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ABSTRACT

This fourth edition of a guide for independent school business managers has been produced in looseleaf format so that changes may be made promptly as decisions of regulatory bodies require modifications in current practice. Fourteen chapters are organized under three broad topic headings. Chapters in part 1, Accounting and Financial Reporting, concern the following subtopics: (1) basic accounting principles; (2) accounting for plant funds; (3) accounting for endowment funds; (4) accounting for operating funds; (5) the chart of accounts; and (6) financial statements. Part 2, Financial Management, contains chapters on: (7) dealing with the independent certified public accountant; (8) budgeting concepts and procedures; (9) cash management; (10) internal controls; (11) endowment management; and (12) financial planning. Part 3, Administrative Issues, contains chapters 13 and 14, which deal respectively with computerization of administrative issues and records retention. A number of exhibits contain sample entries to illustrate the principles explained in the text. (MLF)

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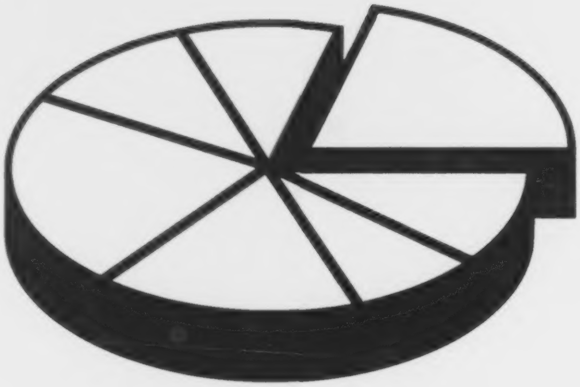

Fourth Edition

National Association of Independent Schools
75 Federal Street
Boston, Massachusetts 02110

EA 022 792

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Foreword

In 1969, the National Association of Independent Schools published the first edition of *Accounting for Independent Schools*, which established principles that have since become generally accepted accounting principles. This common reference point for independent school business managers has given them the opportunity to compare operating results and to benefit from one another's experience.

The first edition of *Accounting for Independent Schools* was produced by a committee consisting of Walter N. Grynwald, Kent School (Conn.); Robert T. Knox, Polytechnic School (Calif.); C. B. Lueck, Pembroke Country Day School (Mo.); John F. Smith, Northfield Mount Hermon School (Mass.); C. Wilson Place, Tilton School (N.H.); Richard Pratt, The Taft School (Conn.); Harold Steinberg, Peat, Marwick and Mitchell; and Carl C. Storey, Princeton Country Day School (N.J.).

Eight years later, a second edition of *Accounting for Independent Schools* was published. The committee producing that edition consisted of Helen L. Diserens, business manager, Rippowam-Cisqua School (N.Y.), chair; Robert C. Barber, business manager, Choate Rosemary Hall (Conn.); William Barrett, director of administrative services, Gill/St. Bernard's School (N.J.); Anthony B. Fruhauf, director of financial affairs, University Liggett School (Mich.); and George A. Neilson, Jr., business manager, Phillips Academy (Mass.)

The committee worked with John Shank, then professor of accounting at the Tuck School of Business, Dartmouth College. Professor Shank, a CPA with a strong interest in independent schools (and a trustee of several), brought fresh insight to the committee's deliberations. He sought to make financial reporting easier to understand for trustees not familiar with the world of fund accounting.

In 1987 the third edition appeared, under the new title *Business Management for Independent Schools*. The committee working on that edition included Cornelius N. Bakker, Jr., business manager, Thayer Academy (Mass.), chair; Helen L. Diserens, business manager, Rippowam-Cisqua School (N.Y.); George Dunnington, business manager, Milton Academy (Mass.); Paul Ness, business manager, Concord Academy (Mass.); James Reagan, business manager, The Williston Northampton School (Mass.); and Charles Scott, business manager, The Taft School (Conn.)

The group decided to model the new edition after *College and University Business Administration*, published by the National Association of College and University Business Officers. In addition to further revising *Accounting for Independent Schools*, the third edition expanded on this base by adding chapters on more general management subjects. Again Professor Shank worked long and hard with the committee. The changes they made, evolutionary in nature, recognized the authority of the previous editions when speaking about accounting issues.

When *Business Management for Independent Schools* was published in 1987, it was agreed that further revisions would be issued sooner than before. The present edition has been produced in looseleaf format so that changes may be made promptly as decisions of regulatory bodies, whether those within the accounting profession or from the federal government, require modifications in current practice. Management issues not addressed in this edition may also be added from time to time.

The committee that produced the 1987 edition continued to work on the present edition, with one exception: Robert Barber, business manager at Choate Rosemary Hall (Conn.), who had served on an earlier committee, replaced Charles Scott, who had retired. We are especially grateful to Nick Bakker for chairing the committee through two editions.

NAIS is grateful to the members of all of these committees, who have given so generously of their time and talent. They represent the most significant asset independent schools have to offer, namely, the great willingness of all who are associated with our schools, whether teachers, parents, or graduates, to work together selflessly to provide the richest possible educational experience for our students.

In addition to our volunteers, we are also grateful to Blackbaud Microsystems, Inc., The Common Fund, Inc., and Coopers & Lybrand for their contributions to this publication.

John C. Esty, Jr.
President, NAIS

Part One.
Accounting and Financial Reporting

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1.
Basic Accounting Principles

Accounting in independent schools, as in all educational institutions, has three objectives.

- To fulfill the obligation of financial stewardship and accountability for the funds entrusted to the school
- To disclose as fully and understandably as possible the results of operations and the financial position of the school
- To provide financial information as an aid to decision making and budgetary control

The accounting principles described here are intended to help achieve these objectives.

The general ledger

A double-entry system of accounting should be used by every school. Single-entry systems, which consist only of cash receipts and cash disbursement registers, do not contain enough information to prove that the school is meeting its stewardship responsibility for the funds it receives. Furthermore, single-entry systems lack the internal control needed to ensure that all transactions and accounting adjustments will be recorded properly.

By using a double-entry system, the school can provide adequately for recording assets, liabilities, fund balances, revenues and other fund additions, expenses and other fund deductions, and interfund transfers, all in balanced fund groups (see "Fund accounting," below.)

The general ledger of the school should contain account groupings for all the funds over which the school has control or from which it is entitled to disburse.

Accrual accounting

To provide adequate information about school operations and thus foster effective administrative control, accounting records should be maintained on the accrual rather than the cash basis. In this way, the accounts reflect all significant amounts receivable and payable, revenues earned, and costs incurred, even though cash may not yet have been received or disbursed.

If items are not recorded until cash is received or disbursed, it is difficult and sometimes impossible to make accurate summaries of the operating results of individual fiscal periods. It is hard, for example, to measure the current year's tuition revenue when the cash basis is used, since cash receipts during the year include some of *this* year's tuition, some of *last* year's tuition (late collections), and some of *next* year's tuition (advance deposits). Furthermore, some of this year's tuition may not be collected until next year. Accrual accounting eliminates this kind of problem.

Depending on the size and capacity of the school's accounting office, accrual accounting can be achieved in one of two ways.

- All revenues and costs are accrued daily in the books of account as part of the normal operations of the accounting system, with revenues and receivables recorded when earned, and expenditures and payables recorded as the related services or materials are received, or
- All transactions (with the possible exception of student billings) are recorded only when cash is received or disbursed, with significant noncash amounts accrued at the end of each fiscal period by making special adjusting journal entries.

If significant month-to-month fluctuations in the school's cash position are typical, it may be desirable to make accrual adjustments at the end of each month to ensure meaningful monthly financial statements. Whether or not accrual adjustments are formally recorded more than once a year, care should be taken, in preparing interim financial statements, that results are fairly presented on an accrual basis.

The second method described above is easier to administer day to day. And, for schools that use a manual accounting system, this approach almost always proves more efficient.

Fund accounting

To account best for the diverse resources available and the diverse uses to which those resources are put, schools should follow the principles of fund accounting.

Definition

Fund accounting is the procedure by which economic resources and obligations are segregated into separate account groupings according to the function or purpose the resources serve. Limitations on the use of monies or assets are of two kinds: restrictions and designations. Restrictions can either be imposed by donors or other external agents, or they can arise from regulations. Designations, made by the board of trustees, can be removed or changed at the board's direction. Fund accounting is a well-established concept ensuring that the school is fully carrying out its stewardship responsibility for all the resources that are entrusted to it.

Basic procedures

Each fund is a separate entity consisting of a balanced set of accounts. The asset accounts of a fund reflect the economic resources committed to the fund. The liability accounts of a fund reflect the economic obligations owed by the fund. The fund balance account reflects the net difference between the total assets and the total liabilities of the fund. The accounts of a fund are therefore in balance at all times: Assets – Liabilities = Fund Balance. In a statement of the financial position of a fund, this relationship is usually shown as Assets = Liabilities + Fund Balance.

All financial transactions involving revenues and other fund additions or expenses and other fund deductions are always recorded within a specific single fund, thus preserving the principles of double-entry bookkeeping for each transaction. Financial reports also should fully reflect the fund groupings that exist in the books of account and make clear the distinction between restricted funds and designated funds, as explained above.

Recommended fund categories

For most independent schools, three major fund categories suffice: operating funds, endowment funds, and plant funds. Some schools might have other categories, such as loan funds or agency funds. The term "operating funds" is preferable to "current funds" or "general funds" because it better conveys the purpose of these funds. When the amounts committed for any of these three purposes are significant, a separate fund or group of funds should be established rather than including the amounts within one of the other major categories.

Some schools include plant assets in the operating fund on the premise that plant assets are used for operations and are often purchased with unrestricted operating funds. Even if restricted funds are used, it is argued that the restriction has been discharged once the plant assets are purchased. This practice is not recommended. Plant assets and any related liabilities should be set up in a separate fund to reflect the distinct, separate purpose served by such assets. *Plant assets should not be merged with operating assets. But, if plant assets are merged into the operating fund, it is very important to show separate fund balance subtotals for operations and for net investment in plant.* These two amounts must be shown separately.

Within each of the three major categories, a further two-way breakdown should be made if the amounts involved are material. Under operating funds, restricted funds should be distinguished from unrestricted funds when "restricted" is used in the strict sense of donor stipulations. Under endowment funds, like operating funds, the distinction is the same: unrestricted funds and restricted funds. Under plant funds, the breakdown is between unexpended and expended amounts. Unexpended plant funds are cash or securities set aside for purchase of plant assets or retirement of plant-related debt; expended plant funds represent cumulative net investment in plant assets.

Classifying invested assets as "endowment" or "operating" depends on whether the school considers the resources themselves available for use or only the income these resources earn. If only the income is available for use, either by restriction or designation, assets should be classified as endowment funds. If the assets themselves may be expended, they should be classified as operating funds.

In summary, where significant amounts are involved, the following three two-part fund categories should be maintained separately in the books of account.

Operating funds

Unrestricted. Economic resources available for any purpose to carry out the objectives of the school

Restricted. Economic resources restricted to specific operating expenses

Endowment funds

Unrestricted. Economic resources invested to produce income that may be used for any purpose to carry out the objectives of the school

Restricted. Economic resources invested to produce income that may be used only for specified purposes

Plant funds

Unexpended. Liquid resources set aside for future investment in plant assets or retirement of plant-related debt

Expended. Plant assets (land, buildings, equipment) of the school and any related liabilities

These categories should also be reflected separately in the financial statements of the school, but with no further breakdown.

Further fund distinctions

Two further fund distinctions can be made: endowment funds and unexpended plant funds.

Endowment funds

Endowment is technically a precise legal term that has a specific meaning under the laws of each state. The concept underlying the term is money contributed to be invested, with only the investment income available for expenditure. Where significant amounts are involved, a more detailed breakdown may be desirable. If the trustees of the school deem it appropriate, the following separate fund groupings may be maintained.

Endowment

Unrestricted. The donor specifies that the principal may not be expended. The income may be used for any purpose the trustees deem appropriate.

Restricted. The donor specifies that the principal may not be expended. The income may only be used for the purposes specified by the donor.

Quasi-endowment or Funds functioning as endowment

Unrestricted. Unrestricted assets of the school are designated for investment by the board of trustees. The principal may only be expended when authorized by the board. Income (and principal, when authorized) may be used for any purpose the trustees deem appropriate.

Restricted. Donor-restricted assets of the school are designated for investment by the board of trustees. The principal may only be expended for the donor-restricted purposes when authorized by the board. The income (and principal, when authorized) may be used only for the purposes specified by the donor.

Term endowment

Term endowment funds are those from outside sources for which the donor has stipulated that the principal is expendable upon the happening of a certain event or after the passage of a stated period of time. Term endowment is usually restricted, but it might also be unrestricted. If significant amounts of both kinds of funds exist, two separate categories would be appropriate.

If these endowment groups are reflected separately in the school's books of account, and if the amounts involved are sizable, a footnote to the financial statements is needed to show the separate fund balances (pure, quasi-, and term) making up the two overall fund balances that are reflected in the statement of financial position for restricted and unrestricted endowment.

Unexpended plant funds

Some schools may wish to break down unexpended plant funds into the following categories.

- Funds accumulated for addition to plant and equipment
- Funds accumulated for retirement of indebtedness on school property
- Funds accumulated for replacement or rental of plant assets

If such a breakdown is maintained, and if the amounts involved are sizable, a footnote to the financial statements is needed to show the separate fund balances that make up the overall fund balance for unexpended plant funds.

Miscellaneous fund categories

The following fund categories, which do not exist in many schools, usually involve insignificant amounts. If they do exist, the following accounting principles should be applied.

Annuity and life income funds

This category is used for funds acquired by the school that carry the obligation to distribute either a fixed income (annuity) or a variable income (life income) to the donor or other designated person during his, her, or their lifetime. Once this obligation is fulfilled, these funds should be transferred either to operating, endowment, or plant funds, as is appropriate.

If annuity or life income funds are not substantial, they may, for financial reporting purposes, be included under endowment funds.

This category does *not* include annuities purchased or owned by the school for the benefit of active or retired employees. Such annuities should be classified under endowment funds. Similarly, this category does not apply to recipients who are current or former employees. Because annuities and life income funds for the benefit of such employees may be subject to the Employee Retirement Income Security Act of 1974 (ERISA), schools should seek advice of counsel before setting up either type of fund out of gifts or other monies.

Agency funds

This category is used to account for funds for which the school is custodian and makes disbursements in accordance with instructions of the person or organization from whom it received the funds. Receipts and disbursements of agency funds should be recorded separately, not as part of the operating funds of the school.

Whenever the school agrees to act as the agent of a separate organization, it is important to have a written agreement covering the school's obligations and the separate organization's obligations. Often managerial and financial issues can be significant for such school groups as the graduates' association, the parents' association, or the annual auction committee. Insurance questions, for example, need to be clarified in advance.

Bringing the financial records for a separate but related organization directly into the school's general ledger is one key way to make sure that proper accounting and financial reporting controls are in place and functioning.

For financial reporting purposes, agency funds are usually included under accounts payable of the unrestricted operating fund. Since agency funds do not belong to the school, any unexpended balance must be presented separately from the fund balances for school-owned funds. If agency funds are not substantial, the balance may, for accounting as well as financial reporting purposes, be included under accounts payable of the unrestricted operating fund. If agency funds are significant, amounts should be disclosed in a footnote.

Miscellaneous funds

If the amounts of loan funds, annuity and life income funds, or agency funds are clearly material, they may be shown separately in the financial statements. If two or more categories are material, they may be combined in one category labeled "miscellaneous funds" for purposes of preparing financial statements for the school. The composition of the combined fund balance should then be shown in a footnote.

Financial reporting

A comprehensive financial report should be prepared once a year for submission to the board of trustees and others authorized to receive it. This report should include

- A comparative statement of financial position (commonly called a "balance sheet")
- A comparative statement of revenues, expenses, and other changes in fund balances
- Footnotes to these two financial statements giving whatever additional information is needed to make the presentation fully informative
- An opinion on the financial statements by an independent certified public accountant

Annual financial report

The annual financial report, which should include all of the items just enumerated, may also include separate schedules that support the financial statements (see examples in Chapter 6), as follows.

- If there are endowment funds, a summary of the composition of investments, a recapitulation of investment income, and, if desired, a detailed listing of all endowment funds
- If significant amounts of gifts or bequests are received, a summary breakdown of sources of gifts and uses to which these gifts are put, with a detailed listing of gifts if desired
- A summary of interfund borrowings if the amounts are significant
- Operating expenses, broken down by function and by object of expenditure

Schedules such as these are not needed to guarantee adequate disclosure, but they may be included when doing so adds significantly to disclosure.

Some schools also include a statement of changes in financial position in their annual financial report. This statement is commonly called "sources and uses of funds" or "funds flow." Inclusion of such a statement in the annual reports of commercial enterprises has been required since 1971. It is not required of colleges and universities, and should not be required of independent schools, either, because nearly all the information this kind of statement presents is already reflected clearly in the statement of revenues, expenses, and other changes in fund balances.

Statement of financial position

The statement of financial position (commonly called the "balance sheet") reflects the assets, liabilities, and fund balance for each fund grouping within the school. It summarizes the financial position of each fund at the end of the fiscal year. I*t is important that the overall financial position of the school be reflected in this statement as well.* While it is true that each fund is an entity that should be reported separately, it is also true that the *primary* entity that interests readers of the financial statements is the school as a whole. The columnar format shown in Chapter 6 is recommended because it best meets these dual objectives. Comparative totals for two years, as illustrated in Chapter 6, should also be presented.

Statement of revenues, expenses, and other changes in fund balances

The statement of the operating fund and the statement of changes in fund balances should be combined into one statement, as shown in Exhibit 6-2. *No information is lost when the two statements are combined, and much new information is gained about the overall operating results of the school.*

A statement of operating funds reflects those operating revenues and expenses of the school for the year that are recorded under operating funds. It also reflects any nonoperating additions to or deductions from operating funds during the year. The distinction between operating and nonoperating items is not carefully drawn because the statement is a summary of *all* activity in the operating funds during the year. The fact that such funds are typically used primarily to record operating items does not mean that *only* operating items are included. In fact, significant nonoperating items are very often included.

A statement of changes in fund balances summarizes all additions and deductions during the year for each of the various fund groupings of the school. Changes in the operating funds are shown in highly summarized form because the activity in these funds is shown in much more detail in the separate statement of operating funds.

No attempt is made in the statement of changes in fund balances to maintain a distinction between operating and nonoperating items because all additions to and deductions from the various fund groupings are being presented. The fact that fund groupings other than operating funds are used primarily to record nonoperating items does not mean that only such items are included. In fact, significant operating items are often included here rather than in the statement of operating funds.

Under the recommended combined report, which uses a columnar format, all activity in each fund grouping is still presented for that grouping. That is, the principle of showing separate fund groups separately is maintained. Each column of the report details all the activity during the year in a particular fund grouping and reconciles the overall change during the year in the fund balance account. A "total" column combines the activity for all the fund groupings.

Each column shows operating items at the top and nonoperating items at the bottom. Thus the operating items in all funds can be summarized by adding together the top portions of each of the columns. The overall operating results for the school can be seen in the top portion of the "total" column of the statement.

The major reason for combining the statement of operating funds and the statement of changes in fund balances is to show overall school operating results more easily without violating the concept of fund reporting as a corollary of fund accounting.

It is sometimes argued that the concept of an operating surplus or deficit has no significance in a school because it is not the function of a school to generate a surplus. Independent schools, however, like all organizations, can only survive in the long run if revenues and other additions cover expenses. *Failure to focus on the overall operating surplus or deficit ignores the most important single indicator of financial health for the school.* This is not to say that deficits are always bad or that surpluses are good. Rather, it means that the concept of looking at operating inflows and outflows together and measuring the net difference is a useful tool for assessing the school's total operating performance.

Consolidated affiliated entities

The financial statements of any development fund, foundation, summer camp, or similar organization that is integrally affiliated with, associated with, or controlled by the school and that operates under section (501)(c)(3) of the Internal Revenue Code should be consolidated with the financial statements of the school. Also to be included are endowment funds held by a separate foundation whose function it is to generate income for use by the school as well as any separate organization that owns all or part of the plant assets used by the school. *Not* included is a foundation that holds investments or property for the benefit of several different schools or nonprofit organizations or any charitable remainder trust, which should not be accounted for until funds are received.

Separate entities should *not* be established to hold investments or property that are for the benefit of only one school. To create separate foundations fragments the administration of the school, causes the problem of overlapping boards, and raises the prospect of disagreement between boards with no convenient way of arbitrating disputes.

Footnotes to financial statements

Footnotes are a convenient device for extending the amount of information disclosed in the financial report without unduly complicating or extending the financial statements themselves. *Footnotes should be considered an integral part of the financial statements.* A footnote should be added wherever the financial statements themselves do not give enough information to show the significance of an item to the overall financial situation.

Footnotes typically include

- Accounting policies followed in areas where amounts are sizable and accounting options are available
- Details of any pension plans, including annual pension expense
- Details of any long-term indebtedness
- The existence and maturity schedule of any large pledges receivable
- The existence of any known charitable remainder trust

Independent auditor's opinion

Every annual financial report of the school should include the opinion of a certified public accountant that the financial statements fairly present the financial position of the school and the results of its operations, in conformity with generally accepted accounting principles for independent schools.

An annual audit of the school's accounts by an independent certified public accountant is an essential control for helping the trustees to fulfill their fiduciary responsibilities. This subject is discussed in more detail in Chapter 7.

Valuation of assets and liabilities

Assets are resources having monetary value that are owned by the school. Liabilities are amounts owed by the school or claims against the school to provide services in the future. Unless otherwise specified in this manual, valuation of assets and liabilities should follow principles generally accepted for commercial enterprises.

Chapters 2-4 consider the accounting principles for plant funds, endowment funds, and operating funds, respectively.

2.

Accounting for Plant Funds

This chapter defines and describes plant assets as well as provision for plant replacement, renewal, and special maintenance.

Plant assets

Plant assets are land, buildings, leasehold improvements, land improvements, and equipment. "Equipment" includes vehicles, furniture, and library books as well as other equipment used in school operations. A piece of equipment is defined as being a physical unit that meets *all* the following conditions.

- It retains its original shape and appearance with use.
- It is nonexpendable; that is, if the article is damaged or some of its parts are lost or worn out, it is usually possible to repair it instead of replacing it with an entirely new unit (which is not true of supplies).
- It represents an investment of money, which makes it possible and advisable to capitalize the item.
- It does not lose its identity through incorporation into a different or more complex unit.

Each school needs a policy on a dollar figure below which expenditures are expensed directly and not capitalized in the plant accounts. A reasonable cutoff figure for most schools would be $1,000. The idea is that only material expenditures are capitalized. The level at which the cutoff figure is used (per item, per invoice, or per check) must be interpreted and judged on a case-by-case basis.

Accounting procedures

Accounting, or bookkeeping, for categories of plant assets varies with the type of asset, as outlined below.

Buildings, land improvements, major leasehold improvements

These assets are not renewable. They are replaced when they wear out. They should be reflected in the books at their original acquisition cost or, in the case of donated assets, at estimated fair value at the date of receipt of the gift. These assets should continue to be carried on the books at their original cost until they are retired from use, at which time they should be removed from the books. Replacements and additions to the asset base should be treated as capital expenditures rather than as operating expenses.

Vehicles, major academic support systems (physical fitness equipment, photography lab, computer center, etc.), office equipment, building components (heating systems, plumbing systems, roofs, etc.)

These are plant assets for which replacement or renewal expenditures tend not to occur in regular annual increments but which represent significant amounts when they do occur. Accounting for the original acquisition and eventual retirement of such items should follow the same approach outlined above for buildings, land improvements, and major leasehold improvements. Accounting for expenditures to renew or replace this category of items should follow the procedures explained below, under "Provisions for plant replacement, renewal, and special maintenance."

Library books, instructional support equipment, athletic equipment

It is recommended practice to expense all purchases in this category so that no asset balances are shown because the amounts involved are not major.

If the items are capitalized, the following procedures should apply. Since these are plant assets for which annual expenditures for expansion or replacement can be budgeted in fairly regular amounts, the assets should be reflected in the books at acquisition cost (or at estimated fair value, for donated assets). This original acquisition amount should be left in the accounts indefinitely, because annual expenditures for replacement and expansion will be considered an operating expense of the school. Since the annual expenditure rate is presumed to be fairly regular, this approach approximates charging each year's operating budget with one year's portion of the wearing out of the assets. Thus the asset accounts continue to reflect the approximate original cost of the asset base being used in the school's operations. If in any one year a part of the year's expenditure represents expansion of the asset base rather than replacement, this part may be capitalized as an addition to plant assets.

To re-emphasize, capitalizing assets in this category is not required for independent schools and is not common practice.

Income-producing assets

Plant assets that are not used for school purposes but are held, instead, to produce income for the school represent a form of endowment. These assets should be recorded under endowment funds, and the income should be considered as investment income. Houses, apartments, or other real property managed for the purpose of generating income are included here. Not included are houses or apartments normally occupied by faculty or staff members, since they represent assets used for "school purposes."

Plant subledger

It is desirable practice to maintain a subledger (subsidiary ledger) listing all plant assets. The total cost should reconcile to the general ledger balances. In practice, very few schools maintain this kind of subledger because one was not started when the school was new, and retrospective reconstruction is not practical. New schools should establish a subledger and keep it up to date.

When a subledger is not practical, it is important that all plant assets be summarized in insurance schedules with approximate fair values. These schedules, which are necessary for fire and casualty insurance purposes, can serve as a substitute for a plant subledger. Schools that want to establish plant accounting records where none have existed before (except aggregate, unreconciled general ledger balances) can start from insurance records.

Auditing of plant funds requires some form of documentation of the existence of assets, exhaustive recorded balances, and valuation bases used.

Depreciation

The Financial Accounting Standards Board has decided to require depreciation by not-for-profit organizations commencing with fiscal years beginning on and after January 1, 1990. NAIS and NACUBO (National Association of College and University Business Officers) raised concerns and objections to the use of depreciation accounting for both theoretical and practical reasons, but those objections were not accepted by FASB. While recognizing the authority of FASB in these matters, a number of colleges and schools have decided to provide funds for the replacement of fiscal assets while not going through the considerable accounting required to depreciate these assets formally on the books. It has been a long-standing principle in accounting that the cost of the accounting procedure should not exceed the value to be gained from doing it.

Readers should be aware, however, that failure to follow the FASB guidelines may result in the school receving a qualified opinion letter from the school's certified public accountant. Such a qualified letter may cause lending institutions and bonding agencies to be uncomfortable with the auditor's opinion. Schools having particular needs in these areas should be careful to explore this issue thoroughly before making a decision.

As this edition goes to press, it is worth noting that a number of influential persons in the college, school, and accounting fields are continuing to try to convince FASB of the error of its decision. Some colleges, universities, and independent schools have decided not to calculate depreciation and to accept a qualified opinion from their auditors.

It should be noted that the requirement by FASB to depreciate does not also include the requirement that such depreciation calculations result in the appropriation of money to cover such depreciation. Thus those schools that follow the FASB guideline will still want to include provision for plant replacement, renewal, and special maintenance (covered in the next section of this chapter, below) in their financial planning.

When depreciation is recorded, the annual increase in accumulated depreciation should reflect the cost of each of the assets (or market value at date of acquisition, for donated assets) divided by the number of years of estimated useful life. This procedure is simply a way of reflecting that these assets are depleted over time. It is not intended to reflect a valuation process, and it does not create funds for replacing the assets. *Furthermore, the amount of annual depreciation is not an expense item of the school.* The next section considers a separate subject: how best to allow in the operating funds for the expense related to use of plant assets. To show plant assets in the balance sheet net of accumulated depreciation is intended only to reflect the fact that, except for land, these assets do have limited life and do wear out eventually. *If plant assets are depreciated, both cost and accumulated depreciation should be clearly disclosed in the financial statements.*

Provision for plant replacement, renewal, and special maintenance (PPRRSM)

Provision should be made among the operating expenses of the school for using up those plant assets listed above as vehicles, major academic support systems, office equipment, and building components. Assets that are donated and for which future replacement is expected to come from future donations do not have to be considered, since operations do not need to generate revenues to cover these expenditures. For many classes of plant assets, however, operating revenues are the principal source of the funds used for replacement or renewal. For these classes of assets, the expenditures should be charged ratably as an operating expense and funded over the years that benefit from use of the assets. This is necessary for three reasons.

- To assess fairly each year the relation between operating revenues and expenses
- To avoid operating at a deficit in the years when major replacements or renewals are necessary
- To provide a pool fund to cover these expenditures so that projects may be scheduled as needed, rather than when it is totally impossible to postpone them any longer.

Purchases of vehicles and other such equipment and expenditures for replacement of major components of buildings such as heating systems, plumbing systems, and roofs should not be recorded as an immediate expense of the operating fund. Operations should be charged ratably over the period during which the assets are used, as explained below. As noted earlier, year-to-year expenditures for equipment, library books, instructional support equipment, and athletic equipment *are* expensed directly. This is acceptable only because the result still approximates charging as expense each year the portion of the asset base used up that year.

The accounting procedure for charging operations ratably for replacement and renewal of vehicles, major academic support systems, office equipment, and building components involves the use of an operating expense account called "provision for plant replacement, renewal, and special maintenance" (PPRRSM). In using this account, the school must first calculate the average amount that would have to be set aside each year to provide money to purchase school equipment (instructional, automotive, kitchen, etc.) as it needs to be replaced, and to provide money for irregularly timed major renewal expenses related to buildings (heating, plumbing, *2-6 • Plant Funds*

electrical, roofs, windows, etc.). This calculation takes into account the following considerations.

- Composition of the school's equipment accounts
- Useful lives of equipment items
- Anticipated costs of replacing equipment as it wears out
- Useful lives of major components of buildings that require periodic replacement if the buildings are to remain usable
- Anticipated costs of these renewal expenditures

After the required average annual expenditure is calculated, this amount is charged against operations as "provision for plant replacement, renewal, and special maintenance," with a corresponding amount of cash set aside in a separate fund within unexpended plant funds. This fund is then invested to earn interest until replacement or renewal expenditures are required. When these expenditures are made, they are charged against this fund, not against operations. School operations will already have been charged each year for a fair share of these expenditures, reflecting the estimated portion of the expenditure used up in any one year.

Once this accounting procedure is instituted, it may take several years to accumulate substantial reserves. The amount set aside annually should be reviewed periodically to assure its adequacy. If the amount is adequate, as outlined above, *the fund called "provision for plant replacement, renewal, and special maintenance" should eventually grow to the point where all replacement and renewal expenditures for vehicles, major academic support systems, office equipment, and building components are provided for*. When this point is reached, the decision about when to make these expenditures can be arrived at rationally, without concern for how much the current operating budget can "afford." The result, over time, should be a significant reduction in the level of important maintenance and renewal projects that have been postponed or "deferred" and an upgrading of the overall condition of the school's operating plant.

All independent schools should provide annually in this manner for the unavoidable wear and tear on those plant assets classified here as vehicles, major academic support systems, office equipment, and building components. *Because these plant assets cannot be presumed to be funded from donations, systematic provision in the operating budget is a necessary aspect of prudent school management*. What is needed obviously depends on the age, type of construction, and condition of the plant assets. At present, a figure ranging between \$.50 and \$1.50 per square foot, or 1 to 2 percent of the replacement cost per year, is used to calculate what is needed for PPRRSM.

PPRRSM • 2-7

In establishing PPRRSM accounting, it is critical to emphasize that PPRRSM is a real operating expense, just as important as faculty salaries. PPRRSM is not an appropriation of surplus. It is also essential to stay with PPRRSM once the policy is established, even in years of particular financial strain.

PPRRSM is a form of replacement cost depreciation funding that is accepted practice for independent schools because it contributes substantially to fair presentation of operating results and to better management of plant replacement and renewal expenditures.

3.
Accounting for Endowment Funds

This chapter discusses investments, investment income, and investment and endowment management policy and expenses.

Investments

A school's investments can consist of securities, of real estate assets held for investment purposes, or both.

Securities

Investment securities should be valued at their estimated fair market value as of the date that financial statements are prepared.

If fixed-return securities (bonds or notes) are acquired at a discount or premium, the discount or premium should be amortized as income until they mature. "Straight line" amortization is permissible when the results are significantly different from those achieved under the conceptually sound but more cumbersome "compound interest" amortization approach (the method of computing interest that is used in bond tables and by banks in drawing up mortgage repayment schedules).

Valuing investment securities at cost is not recommended because market value more accurately reflects current financial position and provides a better basis for measuring investment performance from year to year. The market value method of valuing securities has been generally accepted in investment companies and mutual funds for many years. Additionally, when independent school endowment portfolios are compared for size, they are always shown at estimated fair market value.

Both the cost and the market value of the investment portfolio should be clearly disclosed in the financial report.

Unrealized adjustments to the carrying value of the portfolio should be recorded in a separate fund balance account. Changes in the net balance each year should be reported as nonoperating additions to or reductions in this separate fund balance.

Separate fund balance accounts should also be maintained for the principal sum of investments and for undistributed investment income.

Endowment funds and investment securities owned by other funds may be pooled for investment purposes if permitted by statute and by the terms of the instrument of gift. If securities are pooled, a control account should be maintained to reflect the recorded values of each class of investments in the pool—bonds, preferred stock, and common stock.

Any school that operates an investment pool must adopt procedures to ensure equitable distribution of income and equitable assignment of capital appreciation to all the funds that make up the pool. *The market value method is always used for assigning share value to pooled funds.*

As funds are added to or taken away from the pool, the school must take care to ensure that all funds receive their fair share of investment income as well as unrealized capital appreciation.

The following guidelines for operating investment pools are offered in *College and University Business Administration.*[1]

> Investment earnings are distributed to various participating funds on the basis of the assignment to each fund of a number of units calculated on the market value of assets in the pool at the time of entry of each fund into the pool. This procedure is known as the "market value" or "unit" method of accounting for investment pools. Under this method, when an investment pool is inaugurated, or when a change is made from historic dollar value to market value method, an arbitrary value, perhaps $100, is assigned to a share or unit. Each institutional fund then is considered to have the number of units directly proportional to its historic dollar value at the time the market value is inaugurated. For example, if $100 is assigned for each unit, a fund of $10,000 has 100 shares.

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[1] *College and University Business Administration*, 4th ed. (Washington, D.C.: National Association of College and University Business Officers, 1982), pp. 287-289. Quoted by permission of NACUBO.

Thereafter, the pooled assets are valued at specific intervals, usually monthly or quarterly, and a new unit value is determined by dividing the new total market value by total number of units. This new unit value is used to determine the number of units assigned to, or "purchased" by, a new fund as it enters the pool. The new unit value also is used in calculating the value of a fund that may be withdrawn from the pool. For example, the market value of assets of an investment pool having a total of 100,000 units may be $15 million at a given monthly or quarterly valuation date; the value of each unit, therefore, would be $150 ($15 million divided by 100,000 units). A new fund of $30,000 entering the pool on that date would be assigned 200 units ($30,000 divided by $150). Also, a fund holding 300 units being withdrawn from the pool would have a value of $45,000 (or 300 units multiplied by $150).

In making distributions from the pool, total investment earnings are divided by the average number of units held by all funds participating in the pool during the year or period in order to determine distribution per share. Earnings are distributed at this rate on the basis of number of units held by each fund, with suitable adjustments made for units held for less than a full year or period.

Either of two procedures may be followed in admitting funds to or withdrawing funds from the pool. One is to admit funds to or remove them from the pool only on valuation dates. The other method is to admit or remove them at any time, valuation of units being that of the last valuation date. (Under provisions of the Tax Reform Act of 1969, this method cannot be used for pooled life income funds.) If the latter method is employed, unit values should be determined with sufficient frequency to avoid inequities resulting from undue variations in unit market value.

An account for realized gains and losses on investment transactions usually is established for each investment pool. This account is charged or credited for unit valuation adjustments upon withdrawal of participating funds from the pool. On withdrawal, a fund receives assets equal in value to the market value of the units it held in the pool at withdrawal date or last valuation date. The difference between the historic dollar value on entry and the withdrawal value represents a portion of the aggregate of realized and unrealized gains and losses of the portfolio. Accordingly, on withdrawal of a fund, the difference is charged to the realized gains and losses account as an appropriate disposition of the adjustment. If the aggregate of unit adjustments is material in relation to undistributed realized gains and losses, a separate account could be established and appropriate disclosure made in the balance sheet.

The realized gains and losses account is not assigned shares in the investment pool, and no revenue is distributed to it. Thus, revenue otherwise allocated to the account is distributed to each of the funds participating in the pool in proportion to the number of units held by each fund.

An institution may distribute gains and losses annually to each fund in the pool. However, most institutions do not regard the additional work involved as justified. Realized gains and losses on separately invested funds should be distributed directly to the funds; thus, the fund balance changes each time an investment is sold and a gain or loss is realized.

Buildings or other real estate assets

Buildings or other real estate assets held for investment purposes should be depreciated in computing available income. In this context, depreciation reflects a return of principal and thus should be offset in measuring investment income. This depreciation should be funded because the asset is wasting as time passes. This depreciation expense calculation should be based on expected useful life and expected decline in value (cost less expected eventual salvage value).

Investment income

The full amount of dividends and interest earned during the year should be recorded as investment income of the fund grouping in which the investments are recorded. When investment income from endowment funds is used for operations, it should be recorded as a transfer of funds from endowment to operating. Accordingly, dividends and interest are recognized as revenue in the year earned whether or not the amount is expended for operations. The decision by the trustees to spend income or to reinvest it will determine the size of the transfer to operating funds, but it will not affect the determination of earned income. An alternative procedure that is acceptable but not recommended is to record endowment income directly as revenue of operating funds and to bypass endowment funds altogether when income is received.

If investments are pooled, all income therefrom should first be credited to an undistributed pooled investment income account. Distribution from this account to the various funds comprising the pool should be made at least once a year. As discussed above, this income should be allocated on the basis of the number of shares in the pool held by each fund, adjusted for shares held less than a full year.

For fixed-return securities held, interest income should include amortization of any discount rate or premium.

Investment management policy

Although the management of the school's endowment is described in Chapter 11, some general observations related to accounting are in order here.

First, the basic objective of endowment management is some balance between growth and income yield. Wherever a school falls on this continuum, it is important to make the policy explicit and to reflect it in the accounting records. *What is reported as investment income and what is appropriated for operating purposes annually may not match, and there is no need for them to match.*

Second, it is important to point out that the "total return" concept, which is used by many independent schools, is a management concept, not an accounting concept.

Third, accounting principles for educational institutions do not sanction the recognition of capital gains as operating income. However, this should in no way inhibit the application of the "total return" concept as an investment management policy in those schools that think it has economic merit. As long as capital appreciation appropriated for operations is accounted for as a transfer of funds, "total return" can be applied as an investment management policy without violating the prohibition against recognizing capital appreciation as income.

Endowment management expenses

Management fees and custodial fees related to endowment funds should be recorded as expenses within the endowment funds. They should not be netted against investment income in the books of account. However, for financial reporting purposes, these expenses *are* then netted against investment income.

Proper control of these expenses requires that they be accounted for separately so that they may be tracked as a percentage of the value of invested funds. The transfer of investment income to operations should be net of these expenses.

4.

Accounting for Operating Funds

This chapter considers valuation and financial reporting issues for the principal items within the operating funds of the school.

Assets

Assets reflect economic resources owned or controlled by the school.

Accounts receivable

Uncollected amounts due the school should be recorded at the gross amount legally due. An allowance for uncollectable accounts should be used to ensure that the net amount shown in the financial statements reflects the estimated amount to be received.

Pledges receivable

Pledges receivable (including subscription notes and estate notes) should *not* be recorded in the accounts of the school or shown in the body of the financial statements. However, significant amounts of pledges receivable and their expected maturities should be disclosed in a footnote if it appears likely that they will be collected.

Liabilities

Liabilities reflect economic obligations of the school. Valuation of liabilities for independent schools follows the same principles that are generally accepted for commercial enterprises.

Revenues and other fund additions

Revenues of the school should be recorded on an accrual basis in the appropriate fund grouping and be classified by major sources. These sources include student tuition and fees, investment income (dividends and interest), revenues from auxiliary services (as defined below), revenues from affiliated enterprises (as defined below), other income, and gifts.

Revenues from students

Revenues from students should include all tuition and fees assessed, whether the amounts are collected or not. Uncollectable tuition and fees should be accounted for as a separate operating expense.

If the tuition bill includes a capital assessment, this assessment should be recorded as revenue of the plant fund or the endowment fund, depending on the purpose of the assessment.

Tuition revenue is recorded before deducting financial aid. In other words, tuition revenue should equal the tuition amount per student times the number of students enrolled. Financial aid in the form of scholarships, fee waivers, or tuition remission should not be netted against tuition revenue. *Disclosure is considered adequate only if the gross amount of financial aid is clearly shown, including amounts funded by gifts and other revenue restricted for financial aid.*

Gifts

Gifts are customarily classified as unrestricted or restricted, as described below.

Unrestricted gifts

All unrestricted gifts and bequests should be reported as revenue of the unrestricted operating fund in the year they are received. All cash received in the development office should be immediately transferred to the business office for deposit. If any gift amounts are appropriated for use other than current operations, these amounts should be reflected as transfers from the operating fund to the fund grouping for which they were appropriated.

Another acceptable practice is first to record all gifts in a "development" or unrestricted gift fund and then to transfer amounts to other funds as the trustees deem appropriate. Under this approach, when the gifts are received they are recognized as revenue of the fund to which they are first applied. Subsequent allocations to other funds (including the unrestricted operating fund) are then recorded as interfund transfers.

Restricted gifts

For operations. Restricted gifts for operating purposes may be recorded in one of two ways. Under one approach, they are recorded as revenue of the restricted operating fund when they are received. As they are expended, they will show up as operating expenses in this same fund. If gifts to be spent over more than one year are received, this will result in showing a surplus of revenues over expenses in the restricted operating fund in the year of the gift and a deficit in the following years over which the expenditures are spread. Such a situation requires careful attention in assessing the overall surplus or deficit for the school in the years affected. It is, however, consistent with the concept of recognizing gifts when they are received and expenses when they are incurred.

Under the second approach, the gifts are not treated as income until the year they are expended. When received, a gift is recorded as a deferred credit within the liabilities section of the ledger. As the gift is expended, two entries are made, one charging restricted expenses for the cash expended, and one transferring that portion of the gift from the liability to gift income. This method matches revenues and expenses but does not record gift income as received if the gift is to be spread over more than one year.

The illustrative financial statements in Chapter 6 are constructed by the first method, but this does not imply a preference for that method. In fact, the second method is more widely used.

For endowment or plant. Restricted gifts for endowment or plant should be recorded when received as additions to the fund grouping for which they are intended.

Gifts in kind

Securities. Gifts of marketable securities that are intended to be sold by the school to generate cash should be accounted for as follows. The estimated fair market value of the securities is recorded as gift income at the date of the gift. When the securities are later sold, there will probably be a gain or loss based on the recorded value of the securities. Such gains and losses are accounted for as miscellaneous income or expense in the period of sale.

Other. Items other than marketable securities (paintings, sculpture, antiques, etc.) that the school receives with the intention of disposition to generate cash should be recorded only in a memo account when they are received. When the sale is completed and the net cash proceeds are known, this amount should be recorded as gift income.

Because of the high uncertainty about the amount to be realized from the sale of such items, the gift income should not be recorded until the actual cash amount is known. When acknowledging the gift to thank the donor, it is important that a dollar value not be stated if the gift has not yet been converted to cash. The same procedures are also recommended for securities that do not have a readily determinable market value.

Gifts of non–income-producing assets that are received with the intention of long-term retention should be recorded under plant assets at their estimated fair value at the date of gift.

Tax legislation passed in 1984 regulates appraisals of gifts in kind and imposes reporting requirements on sales or dispositions of such gifts. The law is now complex, and the school must ensure that its procedures are in compliance with the law.

Contributed services or materials and supplies

To assess the full operating expenses of the school properly for purposes of comparison over time and across schools, it is very important to record in the accounts at full value all significant services or materials and supplies used. Accordingly, the estimated fair market value of significant contributed services or materials and supplies must be determined, maintained in the regular operating expense accounts, and reported separately as gift income in the financial statements.

Contributed services include volunteer classroom teachers, teacher aides, library assistants, office help, coaching, legal or auditing services, and other services that, if not donated, would have to be purchased. This category does not include trustees, class agents, parent council members, student work programs, or other services that are uniformly donated, rather than purchased, in independent schools. *To exchange any service for partial or full tuition waivers on a barter basis without full disclosure to the Internal Revenue Service is illegal and can result in loss of the school's tax-exempt status.* The estimated value of contributed services can be determined by looking at the salaries of people who are paid for performing equivalent functions in the school or in similar institutions. Comparative wage and salary data are also available from NAIS, the U.S. Office of Education, and the National Education Association.

Gifts of materials and supplies include food, building materials, vehicles, printing services, and the like. The value of these items for the school's records may be estimated with the aid of dealers in these objects or services, newspaper advertisements, and published price books. If these items are donated with no expectation of gain by the donor, they may be treated as gifts in computing income for tax purposes, in which case the donor should set the value.

Plant asset gifts

Gifts of plant assets should be recorded when received as gift income of the plant fund and as additions to the plant assets. Such gifts should be valued at estimated fair market value at the date of receipt.

Other income

Other income items should not be netted against expenses. These revenues should be separately recorded and, if material, separately reported.

Expenses and other reductions in fund balances

Operating expenses should be recorded in such a way that it is possible to summarize them both in terms of broad functional and departmental categories and in terms of natural expense or "object of expenditure" categories. A proposed classification scheme is given in Chapter 5.

Nothing in this manual should be construed as prohibiting whatever special account procedures or classifications are necessary to comply with regulations or statutes that require special accounting reports.

The major expense categories in the books of account for a day school should be as follows: instruction, operation and maintenance of plant, general and administrative, financial aid, and auxiliary services. Boarding schools should add one more category: boarding services. Expenses of affiliated enterprises, as defined below, constitute a separate category when applicable. This framework should also be carried through to the statement of revenues, expenses, and other changes in fund balances. Classification of individual expense items within these categories is discussed in Chapter 5.

Operating expenses should be recorded first by function, then by department within a function, and finally by object of expenditure within a department.

Faculty salaries

Faculty salaries should be charged as expenses in the fiscal year in which the teaching is done, even if salary payments extend over two separate fiscal years—for example, July and August payments when the school's fiscal year ends June 30.

Salaries paid to faculty members for teaching in summer sessions should not be charged to two separate fiscal years. Instead, the full amount of summer compensation should be charged to the year in which the predominant portion of the summer session falls. As a basic principle, recognition of the expense should correspond to recognition of the revenue.

Provision for plant replacement, renewal, and special maintenance (PPRRSM)

This expense, which charges operations for wear and tear on plant assets, is described in Chapter 2.

Financial aid

Financial aid should be reported on a gross basis as a separate category of expense. Income restricted for financial aid may be disclosed in a footnote. Such income should not be netted against expense for accounting or reporting purposes.

Tuition remission granted in full or in part to children of faculty and staff members is a benefit and should be reported separately and disclosed separately.

The need to meet an ever-expanding demand for financial aid has resulted in the development of a plan to require repayment of part or all of a financial aid award. Schools using this strategy determine the family need and then decide how much must be repaid over time and how much is to be awarded without repayment terms. Since the use of a loan note is necessary to secure the agreement to repay part of the aid package, this aid is often referred to as a loan. (See Exhibit 4-1, at the end of this chapter.) Some confusion has resulted, since the making of a loan presupposes the existence of funds to lend. In this instance, the "funds" are no more than the current appropriation in the operating budget for financial aid. When a financial aid "loan" program is instituted, the school need only ask for repayment of aid that heretofore had been granted without such a condition or requirement.

While there is more than one way to handle the accounting of these loans, it is recommended that they be expensed to the financial aid provision in the operating budget. The loan asset should be described in a footnote to the annual financial statement and picked up as an asset by the endowment fund. That fund will receive all interest and principal payments in a quasi-endowment account whose proceeds are designated to provide income for future financial aid requirements. A bad-debt reserve of 10 percent of the principal balance of outstanding loans should be more than adequate to provide for bad debts if the school's normal accounts receivable collection policies are followed.

Auxiliary services

Auxiliary services include those functions needed to operate the school that are not part of the instructional program: lunchroom, student store, laundry, transportation. Auxiliary services also include summer programs that are not part of the regular academic program of the school.

If the school charges a single combined fee for tuition and meals and room (in boarding schools), it is considered acceptable practice to report the total amount as a lump sum under the heading "tuition" or "student fees." If, however, the school publishes or maintains an internal breakdown of its fees for tuition, meals, room, and other services like health, laundry, or extracurricular activities, the respective revenue amounts should be separately recorded and reported.

Expenses related to auxiliary services should not be netted against revenues in the books of account.

A separate set of expense accounts should be maintained for each auxiliary service to facilitate budgeting for each separate service, which in turn facilitates cost controls through periodic "budget vs. actual" or "year to year" comparisons.

It is especially important to maintain separate accounts for both revenues and expenses for those auxiliary services or miscellaneous costs that are optional and for which fees charged should at least cover costs—the bookstore, a voluntary busing program, a summer camp, or the food service operation.

For financial reporting purposes, all auxiliary services are aggregated and shown as one item of revenue and one item of expense in the statement of revenues, expenses, and other changes in fund balances, as illustrated in Chapter 6.

Affiliated enterprises

Some schools operate business enterprises that are not related to their educational program, such as an inn maintained as a service to people visiting the campus, or a working farm, or a thrift shop operated to generate income for the school. Affiliated enterprises do *not* include the renting of regular school facilities when not needed by the school to generate additional income for operations. Revenue generated from such use is miscellaneous operating income.

Separate revenue and expense accounts should be maintained for each affiliated enterprise so that its economic position can be assessed accurately. For reporting purposes, expenses should be netted against revenues and the net balance be reported as part of miscellaneous income. Legal counsel should be consulted concerning the status of affiliated enterprises for purposes of income taxes and property taxes.

Unrelated business income (UBI) must be reported annually in IRS Form 990-T and taxes (UBIT) must be paid where required.

Interfund borrowings and transfers

All transfers of borrowings between funds should be approved explicitly by the board of trustees. Interfund borrowings should be temporary in nature.

When the expectation of repayment of interfund loans is low, the school should consider recording the transaction as a permanent transfer.

Financial reporting

In the statement of financial position, all interfund balances ("due from" and "due to") for each fund grouping should be netted into one combined amount for each fund grouping and shown as the last item under "assets." When this line is added across the columns for all fund groupings, the combined total will be zero. A separate schedule should be included with the financial report reconciling all "due from" and "due to" balances when these balances are significant. An example of this kind of schedule is shown in Chapter 6.

Netting of interfund liabilities against interfund assets for any fund grouping directly in the books of account is not considered good accounting practice. Such netting is appropriate only for summary financial statement purposes where, as illustrated in Chapter 6, the overall result provides the most informative way of summarizing this aspect of the financial position of the school.

Exhibit 4-1
Sample Tuition Loan Note

SMITH ACADEMY
Tuition Loan Note
(in triplicate)

________________ (city, state)

Student's name ________________ ________________ (day, month, year)

For value received, each of the undersigned, jointly and severally if more than one (hereinafter, collectively and individually, "Borrower"), promises to pay to Smith Academy (the "Academy") or order, at the Academy or at other such location as the holder hereof ("Holder") may designate, the sum of ________________ Dollars ($ __________) (the "Total of Payments") in accordance with the Payment Schedule set forth below.

"Departure Date." As used herein, the term "Departure Date" means July 1 of the first calendar year in which the student listed above is not, by June 30 of such calendar year, enrolled in the Academy for the following academic year.

ANNUAL PERCENTAGE RATE	**FINANCE CHARGE**	AMOUNT FINANCED	TOTAL OF PAYMENTS
The cost of Borrower's credit as a yearly rate	The dollar amount the credit will cost Borrower	The amount of credit provided to Borrower or on Borrower's behalf	The amount Borrower will have paid after Borrower has made all payments as scheduled
%	$	$	$

Payment schedule. The Total of Payments shall be paid in 32 payments, consisting of eight consecutive semi-annual payments of $ ______, to be paid on the first day of each January and July, commencing on the first day of January following the Departure Date (presently estimated to be July 1, 19), followed by 24 consecutive quarterly payments of $ ______, to be paid on the first day of each January, April, July, and October, commencing on the first day of October following the due date of the eighth semi-annual payment.

Prepayment. If Borrower pays off early, Borrower will be entitled to a refund of part of the finance charge.

See the rest of this Tuition Loan Note for additional information about nonpayment, default, any required payment in full before the scheduled date, and prepayment refunds.

Itemization of the amount financed. The entire amount financed of $ __________ is being applied by the Academy, on Borrower's behalf, toward tuition.

Prepayment. Borrower may prepay the unpaid balance of the Total of Payments at any time. If such prepayment is made other than on a scheduled payment due date, it shall be deemed to have been made on the next preceding or next succeeding payment due date (the "Effective Prepayment Date"), whichever is nearer the date of prepayment. In the event of such prepayment on or before the fourth anniversary of the Departure Date, Borrower shall be entitled to a rebate of all finance charge less an amount equal to the sum of payments otherwise required to be paid hereunder on or before the Effective Prepayment Date; and in the event of such prepayment after the fourth anniversary of the Departure Date, Borrower shall be entitled to a rebate of finance charge calculated as of the Effective Payment Date in accordance with the actuarial method.

Default and acceleration. In the event of Borrower's default in the making of any payment hereunder when due, Holder may at any time declare the unpaid balance of the Total of Payments immediately due and payable. If judgment is entered against Borrower as a result of such a default, or if Borrower makes full payment hereof in satisfaction of default, Borrower shall be entitled to and such judgment, if any, shall reflect a rebate of such amount as Borrower would have been entitled to hereunder had Borrower prepaid this Note in full on the date of such judgment or full payment.

Charges upon default. Borrower agrees to pay, to the extent permitted by law, Holder's expenses of enforcement and collection of this Note, including, without limitation, attorneys' fees and costs.

General provisions. Borrower waives all demands and notices relating to this Note. No waiver by Holder of any default shall be effective unless in writing or operate as a waiver of any default on a future occasion. No delay or failure by Holder in enforcing any right hereunder shall operate as a waiver of such right or any other right. This Note shall be governed by [name of state] law. In the event of any conflict between the provisions of this Note and applicable state or federal law, this Note shall be deemed modified to the extent necessary to comply with such law.

Borrower acknowledges receipt of a completed copy of this Note.

Witnessed: Signatures (sign full name in ink):

Borrower [Seal]

Witnessed: Borrower [Seal]

Student [Seal]

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

5.

The Chart of Accounts

The chart of accounts is the system by which financial data are classified and accumulated for clear financial reporting. This chapter outlines the structure of a recommended chart of accounts for independent schools, explains that structure, and describes the accounts contained in the chart. A sample chart of accounts is shown following this format. The chapter concludes with a set of sample journal entries showing how selected representative transactions would be recorded in the proposed coding scheme.

The primary goal of any accounting system is the meaningful disclosure of financial information. The chart of accounts is the first building block in achieving that goal. To promote comparability across schools in categorizing financial information, all schools are encouraged to adopt the concepts contained in this chart of accounts. *Comparability across schools in definitions and descriptions of accounts is more important than uniformity of the number code assigned to those accounts.* Thus schools already having an account numbering system that summarizes financial information in accordance with the categories recommended here do not need to change their existing charts. *Regardless of the numbering system used, all schools are encouraged to adopt the classification and categorization scheme suggested here in the interest of comparability of financial information across schools.*

The structure and numbering scheme outlined below can be regarded as one way for a school to develop financial data within the framework of basic accounting principles. Within that structure and numbering scheme, each school should determine the precise level of detail needed for its own financial reporting and control requirements. Subledgers (subsidiary ledgers) are used to provide additional detail with respect to such accounts as student accounts receivable, payroll, investments, and accounts payable.

Allocating expenses

With only one exception, this chart of accounts does not involve allocation of expenses among major functional categories. The exception is compensation (salary amounts and employee benefits). Compensation cost is allocated to instruction, auxiliary services, plant, and administration in order to reflect fairly the full cost of personnel services within each of these functions. A simple allocation scheme for employee benefits is to charge each of the functions with a share of total payroll taxes and other employee benefits equal to that function's share of total salaries and wages paid by the school.

For other expense items that might benefit more than one function, such as utilities and maintenance, the extra effort involved in allocating the expense is normally not justified no matter what amounts are involved.

Whenever information about the "full cost" of a particular service, program, or function is desired, the "full cost" information should be compiled on a special analysis basis. Determining the cost of a service, program, or function depends heavily on the context in which this cost information is being used. One famous accountant is quoted as saying, in connection with an Interstate Commerce Commission hearing, "Not even God almighty knows the true cost of moving a ton of freight by rail from New York to Baltimore." The kind of cost measurements to be made depends on the kinds of decisions to be made. Cost measurements that apply to pricing decisions, for example, do not necessarily apply to decisions about adding or dropping services. *The chart of accounts is primarily a means of achieving meaningful financial disclosure. When the chart of accounts is used to generate information for decision making, care must be taken in selecting and summarizing the information.*

The coding system

A seven-digit code is proposed for the accounts. The *first digit* specifies the fund grouping. The *second digit* specifies the basic general ledger category (assets, liabilities, etc.). The *third, fourth, and fifth digits* are used to provide detail, as appropriate, within the general ledger categories. The *last two digits* of the account number are used only for operating revenues or expenses. These digits reflect an "object of expense" and "object of revenue" breakdown. A visual overview of the proposed coding scheme is shown in Exhibit 5-1.

This coding scheme is designed to make computerization of the accounting records easy. All account numbers are the same length. Each position within the account number has a particular meaning, as shown in the visual overview. The accounting information can thus be summarized in different ways by sorting records according to different positions in the account code. Sorting on the first digit for "1," for example, summarizes all accounts of the operating fund. Sorting on the second and third digits for "11" summarizes all cash accounts of the school. Sorting on the sixth and seventh digits for "33" summarizes contracted services expense for all departments.

This hypothetical coding scheme is comprehensive enough to cover any independent school. Smaller schools that do not want the full detail provided here may simply skip the accounts that they do not need. The numbering scheme contains enough flexibility to permit the school to add more detail in any area where special circumstances require it. The seven-digit concept requires every account to have exactly seven digits. Zeroes fill out the account description where fewer descriptive digits are used.

What follows is, first, a visual overview of the proposed coding scheme and then the coding scheme itself.

Exhibit 5-1

Visual Overview of Proposed Coding Scheme

- **Fund group**
  - Operating
  - .
  - .
  - .
  - **Ledger category**
    - Assets
    - .
    - .
    - .
    - **Account classification**
      - Cash
      - .
      - .
      - .
      - **Subaccount classification**
        - Cash in bank
        - .
        - .
        - .
    - Liabilities
    - .
    - .
    - .
      - Accrued liabilities –compensation
      - .
      - .
      - .
        - Accrued wages and salaries
        - .
        - .
        - .
    - Expenses
    - .
    - .
    - .
    - **Responsibility center classification**
      - .
      - .
      - English Dept.
      - .
      - .
      - Summer programs
      - .
      - .
      - Trustees
      - .
      - .
      - **Object code**
        - .
        - .
        - Dues & memberships
        - .
        - .
        - Salaries—instructional
        - .
        - .
        - .

Example of an operating expense: 1-5-111-22

1	5	111	22
Operating	Expenses	English Dept.	Dues & memberships

Suggested chart of accounts

In the chart that follows, an asterisk signals "instructional" and "administrative." "Instructional" includes everything related to the intellectual, physical, social, emotional, and spiritual growth of the child. "Administrative" includes general expenses of the school, such as insurance, as well as administrative functions—admission, business, development, head of school—and nonteaching academic administrators.

A. **First digit: fund classification**

1 Operating-unrestricted
2 Operating-restricted
3 Endowment
4 Plant-unexpended
5 Plant-expended
6 Loan

B. **Second digit: general ledger category**

1 Assets
2 Liabilities
3 Fund balances
4 Revenues and gifts
5 Expenses
6 Transfers

C. **Third digit: account classification**

Assets (second digit is "1")
1 Cash
2 Investments
3 Accounts and notes receivable
4 Inventory
5 Prepaid expenses and deferred charges
6 Land, buildings, and improvements
7 Equipment
8 Other assets
9 Interfund balances–due from (fourth digit shows fund grouping *due from*)

Liabilities (second digit is "2")
1 Notes payable–short term
2 Accounts payable
3 Accrued liabilities–compensation
4 Accrued liabilities–other
5 Agency funds
6 Unearned revenues and deferred credits
7 Long-term liabilities
8 Other liabilities
9 Interfund balances–due to (fourth digit shows fund grouping *due to*)

Fund balances (second digit is "3")
1 Unrestricted
2 Temporarily restricted
3 Permanently restricted

Revenues earned (second digit is "4")
1 Student tuition and fees
2 Gifts (alumni/ae, annual, parents, etc.)
3 Student activities
4 Auxiliary services
5 Rentals
6 Dividends and interest
7 Affiliated enterprises
8 Other income

Expenses incurred (second digit is "5")
1 Instructional*
2 Administrative*
3 Plant operations
4 Residential
5 Student activities
6 Auxiliary services
7 Affiliated enterprises
8 Financial aid

Transfers (second digit is "6")
1 Transfers out
2 Transfers in

D. **Fourth and fifth digits: for use when operating expenses and revenues are being recorded**

Departmental and other responsibility center classifications (second digit is "4" or "5")

1xx Instructional (third digit is "1")

101	Administration
102	Art
103	Audiovisual aids
104	Chaplain
105	Classics
106	College counseling
107	Computer
108	Dance
109	Dean of students
110	Drama
111	English
112	Ethics
113	Faculty counseling
114	Foreign language
115	General
116	History
117	Library
118	Mathematics
119	Music
120	Nurse
121	Physical education and health
122	Physical science
123	Religion
124	Social studies
125	Student counseling

2xx Administrative (third digit is "2")

210	Academic
220	Admission
230	Business
240	Development
241	Alumni(ae)
242	Annual campaign
243	Capital campaign
244	General
245	Public relations
246	Special events
250	Financial aid
260	General
270	Grounds
280	Trustees

3xx Plant (third digit is "3")

310	Buildings
320	Faculty housing
330	General
340	Grounds
350	Heating plant
360	Security
370	Vehicles

4xx Residential (third digit is "4")

410	Dining hall (boarding schools)
420	General
430	Health service
440	Housekeeping (dormitories)
450	Laundry

5xx Student activities (third digit is "5")

501	Baseball
502	Basketball–boys
503	Basketball–girls
504	Chess club
505	Club sports
506	Computer sports
507	Crew–boys
508	Crew–girls
509	Cross country–boys
510	Cross country–girls
511	Cycling
512	Debate
513	Fencing
514	Field hockey
515	Football
516	Foreign language clubs
517	General
518	Golf–boys
519	Golf–girls
520	Gymnastics
521	Hockey–boys
522	Hockey–Girls
523	Lacrosse–boys
524	Lacrosse–girls
525	Literary magazine
526	Newspaper
527	Outing club
528	Sailing
529	Skiing
530	Soccer–boys
531	Soccer–girls
532	Softball
533	Squash
534	Swimming–boys
535	Swimming–girls
536	Tennis–boys
537	Tennis–girls
538	Track–boys
539	Track–girls
540	Volleyball–boys
541	Volleyball–girls
551	Water polo
552	Wrestling
553	Yearbook

6xx Auxiliary services (third digit is "6")

610	Athletic store
620	Bus program
630	Dining hall (day schools)
640	General
650	Snack bar
660	Special programs
670	Student store
680	Summer programs

7xx Affiliated enterprises (third digit is "7")

710	Golf course
720	Inn
730	Other
740	School farm
750	Thrift shop

E. Fourth and fifth digits: second digit is "1" or "2" (assets and liabilities)

Assets (second digit is "1")

Cash (third digit is "1")

1x	Cash in bank
2x	Payroll cash
3x	Petty cash
4x	Savings accounts (time deposits)
5x	Money market funds (on-demand withdrawal)

Investments (third digit is "2")

1x	Certificates of deposit
2x	Temporary investments pending sale
3x	Money market funds (time deposits)
4x	Commercial paper
5x	Treasury bills and notes
6x	Mutual funds
7x	Common stocks
8x	Government bonds
9x	Commercial bonds

Accounts and notes receivable (third digit is "3")

1x	Accounts receivable–regular students
2x	Accounts receivable–faculty
3x	Accounts receivable–summer students
4x	Notes receivable
5x	Accrued interest and dividends receivable
6x	Other
7x	Allowance for uncollectable amounts

Inventory (third digit is "4")

1x	Bookstore
2x	Athletic store
3x	Food service
4x	Maintenance supplies
5x	Central stores
6x	Fuel
7x	Other

Prepaid expenses and deferred charges (third digit is "5")

1x	Prepaid insurance
2x	Prepaid subscriptions and dues
3x	Prepaid faculty development
4x	Prepaid financial aid
5x	Prepaid expenses–summer programs
6x	Other

Land, buildings, and improvements (third digit is "6")

1x	Land
2x	Dormitories
3x	Faculty housing
4x	Educational buildings
5x	Buildings
6x	Land improvements
1	Educational
2	Faculty housing
3	Dormitories
4	Other facilities
7x	Construction in progress
8x	Accumulated depreciation

Equipment (third digit is "7")

1x	Equipment
1	Educational
2	Faculty housing
3	Dormitories
4	Other facilities
2x	Vehicles
3x	Computers
4x	Accumulated depreciation

Liabilities (second digit is "2")

Accrued liabilities–Compensation (third digit is "3")

1x	Accrued wages and salaries
2x	Accrued income tax
21	Federal
22	State
23	City
3x	Accrued FICA (employee and employer)
4x	Accrued pension and other capital accumulation plans
5x	Accrued insurance
51	Medical
52	Group life
53	Disability

6x Flexible benefit plan withholding
7x Other

Accrued liabilities–Other (third digit is "4")
1x Accrued interest
2x Accrued insurance
3x Accrued taxes
4x Other

Agency funds (third digit is "5")
1x Alumni(ae) association
2x Parent association
3x Student clubs
4x Class funds
5x Annual auction or raffle
6x Other

Unearned revenues and deferred credits (third digit is "6")
1x Enrollment deposits
2x Prepaid tuitions
3x Deferred gifts

F. **Sixth and seventh digits: for further classifying revenues (object of revenue classifications)**
11 Admission fees for student events
12 Endowment income applied
13 Fines and assessments
14 Merchandise sales
15 Prizes and gifts awarded
16 Restricted gifts received
17 Service sales
21 Short-term investment income
22 Student fees–academic
30 Student fees–activities
41 Student fees–other
42 Tuition–boarding
43 Tuition refund plan
44 Student accident insurance
45 Application fees
61 Tuition–day
62 Tuition–summer programs
63 Undistributed pooled investment income
71 Unrestricted gifts received

G. **Sixth and seventh digits: for further classifying expenses (object of expense classifications)**
01 Advertising
02 Administrative expense applied
03 Benefits–disability insurance
04 Benefits–employee moving expense
05 Benefits–employee professional development
06 Benefits–"family equity plan"
07 Benefits–FICA
08 Benefits–life insurance
09 Benefits–medical
10 Benefits–other
11 Benefits–pensions paid
12 Benefits–retirement plans
13 Benefits–sabbatical leaves
14 Benefits–unemployment tax
15 Books
16 Compensation expense applied
17 Computer hardware
18 Computer software
19 Contracted services
20 Cost of merchandise sold
21 Discretionary fund
22 Dues and memberships
23 Electricity–light and power
24 Equipment purchases expense
25 Films–rental or purchase
26 Financial aid–loans
27 Financial aid–other
28 Financial aid–tuition and fees
29 Food
30 Heating–coal
31 Heating–electric
32 Heating–gas
33 Heating–oil
34 Heating–purchased steam
35 Heating–wood purchase
36 Honoraria
37 Hospitality
38 Insurance–general
39 Insurance–workers compensation
40 Interest expense
41 Investment gains and losses
42 Laundry expense
43 Licenses and permits
44 Microfilm and microfiche
45 Miscellaneous
46 Officiating
47 Periodicals
48 Photocopy
49 Plant expense applied
50 Postage and shipping
51 PPRRSM (provision for plant replacement, renewal, and special maintenance)
52 Printing

53 Prizes and gifts
54 Professional fees–audit
55 Professional fees–legal
56 Professional fees–other
57 Recruiting expense–staff
58 Rent–equipment
59 Rent–real estate
60 Repairs–buildings
61 Repairs–equipment
62 Salaries–instructional
63 Salaries–managerial
64 School catalogues
65 School publications–other
66 Snow removal
67 Supplies–electrical
68 Supplies–instruction materials
69 Supplies–light bulbs
70 Supplies–lumber and hardware
71 Supplies–medical
72 Supplies–office
73 Supplies–paint
74 Taxes–income
75 Taxes–property
76 Taxes–sales and use
77 Telephone–equipment charges
78 Telephone–usage charges
79 Trash removal
80 Travel
81 Tuition remission
82 Uncollectable amounts–provision for
83 Uniforms
84 Vehicle rental
85 Vehicles–gas and oil
86 Vehicles–repair
87 Wages and salaries–part-time
88 Wages and salaries–support
89 Wages and salaries–student
90 Water and sewer

Sample journal entries

In the normal course of operations, individual financial transactions can involve several accounts and more than one fund grouping. *The interrelationship among accounts should not, however, prevent maintaining each distinct fund as a balanced accounting entity.* Thus each transaction must balance in each fund group involved. Because the accounting principles governing the financial activities of independent schools, as described in this manual, are reasonably complex, illustrative original entries for original transactions are included here to help clarify the concepts.

The sample entries that follow are based on the chart of accounts and coding structure given earlier in this chapter. Many of the transactions involving cash receipts and disbursements would probably be recorded initially in a cash receipts or disbursements journal. They are shown here in general journal format for ease of presentation and understanding.

Noncash entries and closing and adjusting entries should always be recorded first in the general journal in the format presented below.

1. *Tuition billing.* Bills of $5,000 each are issued to students for the school year beginning September 1990.

Acct. no.	*Description*	*Dr.*	*Cr.*
1-1-310-00	Accounts receivable–students	1,500,000	
1-4-100-61	Tuition revenues		1,500,000
	To record tuition revenue for the year		

2. *Tuition collection.* Checks totaling $500,000 for tuition are received.

1-1-110-00	Cash–operating	500,000	
1-1-310-00	Accounts receivable–students		500,000
	To record tuition collections		

3. *Gifts received.* A gift for current operations ($500) and a gift restricted for scholarship use ($700) are received from parents.

1-1-111-00	Cash–operating–unrestricted	500	
2-1-111-00	Cash–restricted	700	
1-4-200-71	Gifts–unrestricted–parents		500
2-4-200-16	Gifts–restricted–parents		700
	To record gifts received		

4. *Endowment income.* Dividends of $750 are received from 100 shares of ABC Corporation. These shares are part of the pooled investment portfolio of the endowment funds group and are restricted in use.

3-1-110-00	Cash–restricted endowment	750	
3-4-600-63	Pooled investment income–undistributed*		750
	To record receipt of ABC Corporation dividend		

*Earnings from pooled investments are recorded originally in the restricted endowment funds grouping before they are distributed to the various funds in the pool. See entry 5, below, for an illustration of distribution of income from pooled investments.

5. *Distribution of accumulated pooled investment income.* This journal entry illustrates the annual distribution of pooled investment income to the revenues of the funds that participate in the pool. For purposes of illustration, the "Operating fund–unrestricted" has a 10% interest, the "Operating fund–restricted" a 15% interest, and the "Endowment fund" a 75% interest in the pool.

3-4-600-63	Pooled investment income–undistributed	200,000	
3-1-110-00	Cash–endowment		200,000
2-1-110-00	Cash–restricted	30,000	
2-4-600-12	Endowment income applied		30,000
1-1-110-00	Cash–unrestricted	20,000	
1-4-600-12	Endowment income applied		20,000
3-1-110-00	Cash–endowment	150,000	
3-4-600-12	Dividends and interest earned–unrestricted endowment fund		150,000
	To record annual distribution of pooled investment income		

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Entries

6. *Endowment income applied to operations.* A transfer of $140,000 is made from unrestricted endowment to operations representing a portion of endowment income considered expendable for operations.

Acct. no.	*Description*	*Dr.*	*Cr.*
3-6-100-63	Transfers out–unrestricted endowment	140,000	
3-1-110-00	Cash–unrestricted endowment		140,000
1-1-110-00	Cash–operating	140,000	
1-6-200-63	Transfers in–operations		140,000
	To record "total return" applied to operations		

7. *Invoice—cash basis for recording expense.* A bill of $1,000 is paid for the printing of a brochure used by the admission office.

Acct. no.	*Description*	*Dr.*	*Cr.*
1-5-220-52	Admission office–printing	1,000	
1-1-110-00	Cash–operating		1,000
	To record admission office expense paid in cash		

8. *Invoice—accrual basis for recording expense.* A bill for boiler repair received during the last week in June will not be paid until the next fiscal year, that is, until July. The following entry sets up the account payable. (This procedure may be used throughout the year for full accrual accounting or only at year end to establish the accounts payable liability.)

Acct. no.	*Description*	*Dr.*	*Cr.*
1-5-350-60	Heating plant repairs	952	
1-2-440-00	Trade accounts payable		952
	To set up accounts payable as of June 30		

9. *Invoice—accrual basis for recording disbursement.* The bill for boiler repairs recorded in June is paid in July.

Acct. no.	*Description*	*Dr.*	*Cr.*
1-2-440-00	Trade accounts payable	952	
1-1-110-00	Cash–operating		952
	To pay bill set up as accounts payable at June 30		

10. *Purchase of equipment.*

a. The school buys equipment for the heating plant that is *capitalized.*

Acct. no.	*Description*	*Dr.*	*Cr.*
5-1-650-00	Equipment–heating plant	5,000	
4-6-100-00	Transfers out–plant–unexpended	5,000	
5-6-200-00	Transfers in–investment in plant		5,000
4-1-110-00	Cash–plant funds unexpended		5,000
	To record purchase of equipment		

b. The school buys equipment that is *charged to expense.*

Acct. no.	*Description*	*Dr.*	*Cr.*
1-5-117-15	Library–book expense	300	
1-1-100-00	Cash–operating		300
	To record expense for library books purchased		

11. *Retirement of plant assets.* Academic equipment purchased from restricted funds and originally costing $2,000 is scrapped.

Acct. no.	*Description*	*Dr.*	*Cr.*
5-3-300-00	Fund balance–investment in plant	2,000	
5-1-711-00	Equipment–academic		2,000
	To scrap equipment no longer in use		

Acct. no.	*Description*	*Dr.*	*Cr.*

12. *Recording the provision for plant replacement, renewal, and special maintenance (PPRRSM) as an operating expense.*

1-5-330-51	Provision for plant replacement, renewal, and special maintenance	75,000	
1-1-110-00	Cash–operating		75,000
5-1-110-00	Cash–plant funds	75,000	
5-6-200-00	Transfers in–plant funds unexpended		75,000

To record the funding of PPRRSM for the year

13. *Financial aid*

a. Financial aid totaling $200,000 is granted.

1-5-800-28	Financial aid–tuition	200,000	
1-1-310-00	Accounts receivable–students		200,000

To record financial aid for the year

b. At year end, $50,000 of restricted funds is applied against the financial aid of $200,000 already granted

2-5-800-28	Financial aid–tuition	50,000	
2-1-110-00	Cash–restricted		50,000
1-1-110-00	Cash–operating	50,000	
1-5-800-28	Financial aid–tuition		50,000

To record the application of restricted funds to financial aid

14. *Payroll.* This simplified example illustrates the recording of a payroll. As can be seen, it consists of distributing salaries to the functional expense accounts, recording employee benefits expenses, disbursing cash, and posting the liability accounts for payroll withholdings. This payroll covers a monthly pay period for one faculty member, one administrator (admission office), and a building custodian. The school pays all hospitalization insurance and matches pension contributions.

a. The payroll journal

1-5-115-62	Instruction–faculty salaries	3,000	
1-5-220-63	Administration–admission salaries	2,000	
1-5-330-88	Plant–cleaning–wages	1,000	
1-1-120-00	Cash–operating–payroll		3,000
1-2-330-00	Taxes payable–FICA (7.65%)		460
1-2-322-00	Taxes withheld–state income tax		480
1-2-321-00	Taxes withheld–federal income tax		1,800
1-2-340-00	Retirement insurance payable		300

To record the payroll of September 1990

b. Employee benefits expense for the payroll

1-5-260-07	Employee benefits–FICA tax	460	
1-5-260-09	Employee benefits–medical and hospital insurance	330	
1-5-260-12	Employee benefits–retirement insurance	300	
1-2-330-00	Taxes payable–FICA		460
1-2-340-00	Retirement insurance payable		300
1-2-351-00	Accrued medical and hospital insurance		330

To accrue employee benefits for the payroll of September 1990

Acct. no.	*Description*	*Dr.*	*Cr.*

c. Payment of a liability for employee benefits accrued

1-2-351-00	Accrued medical and hospital insurance	330	
1-1-110-00	Cash–operating		330

15. *Distributing employee benefits*

1-5-115-16	Instruction–employee benefits applied	525	
1-5-230-16	Administration–admission–employee benefits applied	350	
1-5-330-16	Operation and maintenance of plant–cleaning–employee benefits applied	175	
1-5-260-16	Employee benefits applied		1,090*

To distribute employee benefits to the
functional expense categories based on salaries paid

*In this simplified example, the $1,050 of employee benefits is distributed to the departments in proportion to the salaries of each department

Department	*Salary*	*Portion of total*	*Portion of employee benefits*
Instruction	3,000	1/2	545
Administration –admission	2,000	1/3	365
Plant	1,000	1/6	180
Totals	6,000	1.0	1,090

As employee benefits are distributed, account 260-16 accumulates total credits equal to the sum of all the debits for employee benefits charged to accounts 260-03 through 260-14. Thus, benefits charged to department 260 eventually zero out, with the benefits being distributed to other departments based on salaries and wages paid in the departments.

16. *Provision for uncollectable accounts*

a. Operating expenses are charged to the estimated cost of uncollectable accounts.

1-5-260-82	Provision for uncollectable accounts	1,000	
1-1-370-00	Allowance for uncollectable accounts		1,000

To provide for expected uncollectable student accounts

b. Actual accounts that become uncollectable are charged off.

1-1-370-00	Allowance for uncollectable accounts	500	
1-1-310-00	Accounts receivable–students		500

To record accounts written off as uncollectable

c. Accounts previously written off are recovered

1-1-110-00	Cash–operating	250	
1-1-370-00	Allowance for uncollectable accounts		250

To record amounts received on accounts previously written off

Acct. no.	*Description*	*Dr.*	*Cr.*
17. *Merchandise held for sale*			
	a. The school purchases merchandise for resale.		
1-1-410-00	Inventory–bookstore	3,000	
1-1-110-00	Cash–operating		3,000
	To record merchandise purchased by the bookstore		
	b. Based on a physical count at year end, it is determined that $90,000 worth of merchandise was sold during the year.		
1-5-670-20	Bookstore–cost of goods sold	90,000	
1-1-410-00	Inventory–bookstore		90,000
	To record cost of merchandise sold		
18. *Tuition deposits received in advance*			
1-1-110-00	Cash–operating	300,000	
1-2-610-00	Unearned revenues		300,000
	To record the receipts of a $1,000 tuition deposit from each of 300 students, applicable to next year's tuition		
19. *Expenditures from the PPRRSM fund*			
5-1-711-00	Equipment–academic	30,000	
5-6-200-00	Transfers in–plant–expended		30,000
4-6-100-00	Transfers out–plant–unexpended	30,000	
4-1-110-00	Cash–plant–unexpended		30,000
	To record $30,000 of instructional equipment purchased from the PPRRSM fund		
20. *Equipment purchased from operating cash, with a due from/due to*			
5-1-711-00	Equipment–academic	10,000	
5-2-910-00	Due to operating–unrestricted		10,000
1-1-950-00	Due from plant–expended	10,000	
1-1-110-00	Operating cash		10,000
	To record a loan to the plant fund for assets purchased with operating cash		

6.

Financial Statements: The School's Annual Financial Report

Once the financial activities of the school for the year have been properly recorded in the books of account, the information must be summarized in a format that clearly presents the financial position of the school at the end of the year and the results of the school's operations during the year.

This chapter illustrates financial statements and related supporting schedules for a hypothetical independent school, following the accounting and reporting principles set forth in Chapters 1-5.

The purpose of these illustrative statements is to indicate a general format for the minimum information recommended, not to provide an exact example. Good judgment must still be exercised to strike a proper balance between conformity with other independent schools and full and meaningful disclosure of the particular financial situation of the individual school. Naturally, items that are not applicable are not reported. On the other hand, if a school wishes to report in greater detail than is shown here, it may expand any of the statement classifications or provide additional supporting schedules to present such detail. It is important to remember, however, that condensed, highly summarized financial statements help to highlight essential financial information.

Financial statements illustrated in this chapter are

- Statement of Financial Position (Exhibit 6-1)
- Statement of Revenues, Expenses, and Other Changes in Fund Balances (Exhibit 6-2)

Examples of typical kinds of footnotes required to achieve full disclosure are given in Exhibit 6-3.

In addition, the following supporting schedules are illustrated.

Schedule of Invested Funds (Exhibit 6-4)
Schedule of Gifts Received (Exhibit 6-5)
Schedule of Interfund Balances (Exhibit 6-6)
Reconciliation of Expenses by Function and by Object of Expenditure (Exhibit 6-7)

This set of statements and supporting schedules constitutes the minimum that a school should prepare at the end of each fiscal year. Additional statements or schedules, such as a more detailed schedule of operating expenses or operating revenues, may be prepared if they will add significantly to an understanding of the school's financial condition and the results of its operations. The publication of additional statements or schedules should, however, be approached with caution, since providing *too much* information can inhibit examination and understanding just as much as providing *too little* information. Concise and clear financial reporting is the objective.

Many trustees and others associated with the school find it difficult to extract the essential messages from the annual financial report of the school. To address this need, many schools prepare supplementary financial statements using nontechnical language. Examples of such an approach are shown in Exhibits 6-8 and 6-9. Each school should consider preparing and distributing simplified, condensed statements like these as a way of promoting broader understanding of the school's basic financial situation among trustees and other friends of the school who do not have a strong background in finance.

Exhibit 6-1
The Independent School
Statement of Financial Position
Year ended June 30, 1990

	Year ended June 30, 1990							*All funds combined, year ended*
	Operating funds		*Endowment funds*		*Plant funds*		*All funds*	
	Unrestricted	*Restricted*	*Unrestricted*	*Restricted*	*Unexpended*	*Invested*	*combined*	*June 30, 1989*
Assets								
Cash	36,000	3,000	30,000	57,000	189,000		315,000	420,000
Investments–at market (see Exh. 6-4)	105,000	21,000	939,000	300,000	30,000		1,395,000	1,248,000
Accounts receivable	102,000						102,000	99,000
Inventories–at cost	21,000						21,000	27,000
Land and buildings–at cost						6,525,000	6,525,000	6,510,000
Equipment–at cost						369,000	369,000	357,000
Other assets	51,000						51,000	51,000
Subtotal	315,000	24,000	969,000	357,000	219,000	6,894,000		
Interfund balances–net (see Exh. 6-6)	(36,000)	57,000	21,000		6,000	(48,000)		
TOTAL	279,000	81,000	990,000	357,000	225,000	6,846,000	8,778,000	8,712,000
Liabilities								
Accounts payable	27,000						27,000	24,000
Accrued liabilities	12,000						12,000	24,000
Unearned revenues	258,000						258,000	249,000
Mortgages payable (see Exh. 6-3, n. 2)						393,000	393,000	549,000
Total liabilities	297,000					393,000	690,000	846,000
Fund balances	(18,000)	81,000	990,000	357,000	225,000	6,453,000	8,088,000	7,866,000
TOTAL	279,000	81,000	990,000	357,000	225,000	6,846,000	8,778,000	8,712,000

Exhibit 6-2

The Independent School

Statement of Revenues, Expenses, and Other Changes in Fund Balances

Year ended June 30, 1990

	Year ended June 30, 1990							*All funds combined, year ended June 30, 1989*
	Operating funds		*Endowment funds*		*Plant funds*		*All funds combined*	
	Unrestricted	*Restricted*	*Unrestricted*	*Restricted*	*Unexpended*	*Invested*		
Revenues								
Tuition and fees	2,730,000						2,730,000	2,706,000
Dividends and interest earned	6,000		45,000	15,000	18,000		84,000	78,000
Auxiliary services	333,000						333,000	327,000
Other (see Exh. 6-3, n. 5)	78,000						78,000	78,000
TOTAL	3,147,000		45,000	15,000	18,000		3,225,000	3,189,000
Expenses (see Exh. 6-7)								
Instruction and student activities	1,794,000	87,000					1,881,000	1,803,000
Auxiliary services	627,000	18,000		3,000			648,000	618,000
Operation and maintenance of plant	540,000	21,000					561,000	510,000
General and administrative	390,000	6,000	15,000				411,000	375,000
Financial aid and other		111,000					111,000	117,000
TOTAL	3,351,000	243,000	15,000	3,000			3,612,000	3,423,000
Surplus (deficit) before gifts	(204,000)	(243,000)	30,000	12,000	18,000		(387,000)	(234,000)
Gifts received (see Exh. 6-5)	168,000	210,000	138,000	90,000	6,000		612,000	225,000
Surplus (deficit) after gifts	(36,000)	(33,000)	168,000	102,000	24,000		225,000	(9,000)
Other changes in fund balances								
Interfund transfers								
Dividends and interest applied	39,000	18,000	(39,000)	(18,000)				
Capital appreciation applied	9,000	3,000	(9,000)	(3,000)				
Mortgage principal paid					(156,000)	156,000		
Purchase plant assets								
Buildings					(75,000)	75,000		
Equipment					(72,000)	72,000		
Provision for PPRRSM*					150,000		150,000	135,000
Plant assets retired								
Buildings						(60,000)	(60,000)	
Equipment						(60,000)	(60,000)	(36,000)
Change in market value of investments	(6,000)	(3,000)	(18,000)	(6,000)			(33,000)	(63,000)
TOTAL	42,000	18,000	(66,000)	(27,000)	(153,000)	183,000	(3,000)	36,000
NET CHANGE FOR THE YEAR	6,000	(15,000)	102,000	75,000	(129,000)	183,000	222,000	27,000
FUND BALANCE–BEGINNING OF YEAR	(24,000)	(96,000)	888,000	292,000	354,000	6,270,000	7,866,000	7,839,000
FUND BALANCE–END OF YEAR	(18,000)	81,000	990,000	357,000	225,000	6,453,000	8,088,000	7,866,000

*Provision for plant replacement, renewal, and special maintenance. See Chapter 2 for an explanation of this item. See Chapter 5, sample journal entries 11 and 19, for an illustration of the bookeeping procedure.

Exhibit 6-3

Notes to the Financial Statements

1. *Accounting policies.* Investments are valued at estimated market value. The school uses the "total return" method of determining investment income available for operations. Inventories are valued using the First-In, First-Out (FIFO) system. Property assets are recorded at acquisition cost. Although property assets are not depreciated, in accordance with recommended accounting practices for independent schools, provision is made among the operating expenses for the average annual expenditure related to providing for plant replacement, renewal, and special maintenance (PPRRSM). PPRRSM accounting, which is forward-looking and based on current values, better reflects the basic impact on operations of plant wear and tear than does depreciation accounting, which is just the pro rata amortization of original acquisition costs. Pledges are not recorded until they are paid.

2. *Long-term debt*

	1989	*1990*
Mortgage notes payable		
Federal Savings Bank 11% demand	18,000	24,000
Federal Savings Bank, 11 1/4% (1988, 11 1/2%), demand first mortgage	345,000	255,000
Paul Martin, no interest, $150,000 payable October 1, 1988, and $90,000 payable April 1, 1989, second mortgage		240,000
Other note payable–Janet Ashe, 10% demand	30,000	30,000
Total	393,000	549,000

The 11 percent mortgage note payable is collateralized by the Hartford Building. The first and second mortgage notes payable are collateralized by property located at 40-44 Maple Street. Payment of Paul Martin's mortgage note was made with (1) the proceeds from the increase of $90,000 in the Federal Savings Bank first mortgage note payable and (2) Martin Property Fund cash of $150,000. Interest expense is included in general expenses.

3. *Pension plans.* All school employees are eligible for retirement benefits under the federal social security system. Eligible employees are also covered by TIAA/CREF (Teachers Insurance Annuity Association/College Retirement Equities Fund. Pension expense for 1989 was $78,000.

4. *Unrecorded contingent assets.* The school has uncollected pledges receivable under the capital gifts program totaling $525,000, which are due over a three-year period. These pledges are not recorded in the financial statements because they do not represent legal obligations. The school is a beneficiary under several charitable remainder trusts. The amount the school will ultimately receive from such trusts cannot reasonably be determined at this time.

5. *Detail of other revenues*

	1989	*1990*
Rentals	57,000	60,000
Sale of equipment	9,000	6,000
Miscellaneous	12,000	12,000
Total	78,000	78,000

Exhibit 6-4

The Independent School
Schedule of Invested Funds

Year ended June 30, 1990

	1990		*1989*		*Dividends & interest*	
	Market value	*Cost*	*Market value*	*Cost*	*1990*	*1989*
Invested funds						
Government securities	90,000	90,000	90,000	90,000	6,000	6,000
Corporate bonds	135,000	150,000	144,000	135,000	12,000	12,000
Preferred stock	150,000	180,000	162,000	180,000	9,000	9,000
Common stock	1,020,000	543,000	852,000	468,000	36,000	27,000
Subtotal–investments	1,395,000	963,000	1,248,000	873,000	63,000	54,000
Cash invested*	267,000	267,000	342,000	342,000	21,000	24,000
TOTAL	1,662,000	1,230,000	1,590,000	1,215,000	84,000	78,000

*Included with cash in the statement of financial position.

Exhibit 6-5

The Independent School
Schedule of Gifts Received
Year ended June 30, 1990

	Uses of gifts							
	Operations		*Endowment*		*Plant*		*All funds combined, year ended*	*All funds combined year ended*
Sources of gifts	*Unrestricted*	*Restricted*	*Unrestricted*	*Restricted*	*Unexpended*	*Invested*	*June 30, 1990*	*June 30, 1989*
Alumni(ae)	30,000	15,000	75,000				120,000	39,000
Parents	102,000						102,000	66,000
Trustees		75,000	15,000				90,000	60,000
Grandparents	36,000	54,000					90,000	
Friends		66,000	48,000	30,000	6,000		150,000	60,000
Corporations				15,000			15,000	
Foundations				45,000			45,000	
TOTAL–Year ended 6/30/90	168,000	210,000	138,000	90,000	6,000		612,000	225,000
TOTAL–Year ended 6/30/89	117,000	105,000	3,000				225,000	

Exhibit 6-6

The Independent School
Schedule of Interfund Balances
Year ended June 30, 1990

	Due to						
	Operating		*Endowment*		*Plant*		
	(1) Unrestricted	*(2) Restricted*	*(3) Unrestricted*	*(4) Restricted*	*(5) Unexpended*	*(6) Invested*	*(7) Total*
Due from							
Operating–unrestricted		57,000			6,000		63,000
Operating–restricted							
Endowment–unrestricted							
Endowment–restricted							
Plant–unexpended							
Plant–invested	27,000		21,000				48,000
Total due from	27,000	57,000	21,000		6,000		111,000
Total due to (col. 7)	(63,000)					(48,000)	(111,000)
Net interfund balances Due from/(Due to)	(36,000)	57,000	21,000		6,000	(48,000)	

Exhibit 6-7

The Independent School

Reconciliation of Expenses by Function and by Object of Expenditure

Year ended June 30, 1990

	Function					
	Instruction and student activities	*Auxiliary service*	*Operation and maintenance of plant*	*General and administrative*	*Financial aid and other*	*Total*
Object of expenditure						
Salaries and wages	1,326,000	204,000	228,000	245,000		2,003,000
Employee benefits	264,000	42,000	45,000	57,000		408,000
Materials and supplies	204,000	303,000		24,000		531,000
Utilities and other plant expenses	12,000	27,000	288,000			327,000
Information and communications	30,000			27,000		57,000
General expenses (including interest)		15,000		58,000		73,000
Other expenses	45,000	57,000				102,000
Financial aid					111,000	111,000
TOTAL	1,881,000	648,000	561,000	411,000	111,000	3,612,000

6-10 • Exh. 6-8

Exhibit 6-8

The Independent School

Condensed Statement of Financial Position

Year ended June 30, 1990

	How much we own (Assets)	*less*	*How much we owe (Liabilities)*	*equals*	*Our net worth (Fund balance)*
For each fund group					
Operating funds–unrestricted	315,000		330,000		(18,000)
Operating funds–restricted	81,000				81,000
Endowment funds–unrestricted	990,000				990,000
Endowment funds–restricted	357,000				357,000
Plant funds–unexpended	225,000				225,000
Plant funds–investment in plant	6,894,000		441,000		6,453,000
Less internal adjustments	(84,000)		(84,000)		
For the entire school, combined	8,778,000		690,000		8,088,000

Notes

Restricted funds are those established by a donor for a specific purpose.

Endowment funds represent money set aside for investment. The money earned each year by endowment funds goes for school operations.

"Plant funds–unexpended" represents money set aside for future purchases of plant assets such as equipment or vehicles.

Exhibit 6-9

The Independent School

Condensed Statement of Operations and Other Changes in Fund Balances

Years ended June 30, 1990 and 1989

	Fund groups			*For the school as a whole*	
	Operating funds	*Endowment funds*	*Plant funds*	*All funds combined, 1990*	*All funds combined, 1989*
Operating revenues	3,147,000	60,000	18,000	3,225,000	3,189,000
Operating expenses	3,594,000	18,000		3,612,000	3,423,000
Difference, before considering gifts	(447,000)	42,000	18,000	(387,000)*	(234,000)*
Gifts received	378,000	228,000	6,000	612,000	225,000
Difference, after gifts	(69,000)	270,000	24,000	225,000	(9,000)
Transfers between funds	69,000	(69,000)			
Other changes–net	(9,000)	(24,000)	30,000	(3,000)	36,000
Net change for the year	(9,000)	177,000	54,000	222,000	27,000
Add					
"Net worth," beginning of year	72,000	1,170,000	6,624,000	7,866,000	7,839,000
Equals					
"Net worth," end of year	63,000	1,347,000	6,678,000	8,088,000	7,866,000

*We believe it is important to call your attention to the fact that, *before considering gifts, the school operated at a deficit of $387,000 this year and $234,000 last year*. In short, operating revenues do not cover the cost of our excellent academic program. We rely each year on the generous support of our many friends to meet this deficit. Without such continuting support, we could not offer the same academic program.

Part Two.
Financial Management

7.

Dealing with the Independent Certified Public Accountant

Every independent school should engage an independent certified public accountant to conduct an annual audit of its financial records. The practice of obtaining an unaudited review violates a basic tenet of prudent financial management and is considered unacceptable. An annual audit is imperative in helping the school's trustees meet their fiduciary responsibilities.

Services provided by the CPA

Although the annual audit is the principal service provided by the independent auditor, he or she can also provide other services to the school. Following is a summary of these services.

The annual audit

The primary service the CPA provides is the annual examination of the school's financial records. This examination should be conducted in accordance with the generally accepted auditing standards set by the Auditing Standards Board, which functions under the auspices of the American Institute of Certified Public Accountants. The annual audit involves an analytic review of the school's operations, review and testing of the school's internal control systems, tests for accuracy of the accounting records, and verification of significant asset and liability balances. When the annual audit is completed, the auditor prepares a letter expressing an opinion about the financial statements of the school.

In addition to the auditor's opinion letter, the trustees should also receive each year, as a result of the audit, a commentary by the auditor on the overall financial management practices of the school, with suggested improvements. Such commentary is typically called a "management letter." Any auditor who fails to provide a management letter each year is not giving the school the full service to which it is entitled.

Bookkeeping services

The CPA can take responsibility for maintaining the basic books of account for the school, which includes recording all transactions and all necessary adjusting entries in the books of original entry and maintaining the general ledger.

Providing basic bookkeeping and accounting services is called "write up" work. Individual CPA's and small accounting firms are usually more interested in providing such services than are larger firms. Using the write-up services of a local CPA may be a cost-effective step for schools that cannot afford a full-time business manager.

When a CPA is engaged to provide basic bookkeeping services, consideration of independence, both real and apparent, suggests that another person or firm be engaged to audit the school's financial statements.

Periodic preparation or review of financial statements

If the financial record keeping is done by someone on the staff of the school who is a bookkeeper but not an accountant, the CPA can take responsibility for preparing monthly or quarterly financial statements. Such interim information is of great value to the head of the school and the finance committee of the board of trustees in reviewing and monitoring results of operations as the year progresses. In constructing interim financial statements, the CPA first reviews the books and records to make sure that all significant items are properly reflected.

Even if the school's business manager is responsible for preparing the interim financial statements, the trustees sometime deem it desirable to have the CPA review them periodically as an independent check on their accuracy and significance. Such periodic review by the CPA also ensures that no accounting or reporting problems arise that might cause delay or other difficulties in the year-end audit.

Consulting and financial advisory services

The CPA can undertake specific consulting projects involving improvements to the basic accounting system, the reporting system, financial controls, budgeting and financial planning systems, and systems for managing such items as cash, accounts receivable, and accounts payable. The CPA's expertise as a financial professional and familiarity with the school offer significant advantages when the school is thinking about using a consultant.

The CPA should always be available to answer specific accounting questions, to offer suggestions on how to conduct the administrative aspects of the school's operations, and to give advice on managing the school's financial resources and obligations. Such advice and counsel are part of the basic service rendered by the CPA.

The CPA, as well as the school's legal counsel, can also help the school monitor its compliance with the provisions of the myriad legislation that applies to independent schools but is not widely understood, such as the Employment Retirement and Security Act (ERISA), Equal Employment Opportunity (EEO), the Occupational Safety and Health Act (OSHA), and the like. The business officer ordinarily is not familiar with the various forms that must be filed under these laws.

Taxation services

Even though the independent school is exempt from income and valuation taxes, there are still many ways in which the CPA can be helpful in this area.

For example, the CPA, as well as the school's legal counsel, can advise on preparing the annual federal information return (Form 990) for the school. Similarly, the CPA can help determine whether the school is required to file the federal tax return for unrelated trade or business taxable income (Form 990-T) and advise on its preparation if it must be filed.

The CPA can also help review federal, state, and local payroll tax returns for the school, give advice on compliance with state sales or use tax regulations, and help the school in complying with local property tax regulations. *The school's business officer should take responsibility for preparing all tax returns and call on the CPA only for advice.*

The management letter

A significant feature of the annual audit is the management letter. This letter is part of the audit engagement fee, not an extra cost option. It encompasses deficiencies in the accounting record keeping and control features relating to segregation of duties, as well as other financial management concerns the auditors deem in need of review and correction. In addition, this letter often includes broader suggestions designed to improve the overall management of the school.

A draft copy of the management letter should be presented to the business manager for review before it is put into final form. This review helps to prevent ill-informed or incorrect observations from being presented to the audit committee. Once reviewed, the letter is put into final form and directed to the treasurer of the board of trustees.

The auditor's opinion

The annual audit should be of sufficient scope to allow the auditor to express an unqualified opinion about the school's financial statements. Exhibit 7-1, at the end of this chapter, illustrates the preferred form for an unqualified opinion for an independent school.

Three aspects of this "standard" opinion are worthy of particular mention.

First, the opinion should refer to fair presentation of the financial position of the school as a whole, not just to the financial position of each of the fund groupings. The opinion should not refer to the financial position of individual fund groupings within the school. Since the primary entity of interest to the reader of the financial statements is the school as a whole, the auditor should express an opinion about the reported financial position of the school as a whole.

Second, the opinion should refer to fair presentations of the results of operations for the school, not just to fair presentation of receipts or revenues, expenditures or expenses, transfers, and other changes in fund balances. Specific mention of the results of operations for the school is recommended. When the auditor's opinion refers only to fair presentation of additions to, and deductions from, fund balances of separate fund groupings, it is not clear that the combined amounts present fairly the operating results for the school as a whole.

Third, the opinion should state that the financial statements have been presented in accordance with generally accepted accounting principles for independent schools. There are significant areas in which accounting for educational institutions does not conform to accounting for commercial enterprises. Major areas of difference include the use of fund accounting, nonrecognition of depreciation, the use of the market method for valuing investment securities, and the absence of a "net income" concept. Because school accounting principles do differ in some significant ways from business accounting principles, it is important that the reader of the financial statements be made aware that it is school accounting principles that are being followed. For this reason, it is recommended that the reference in the auditor's opinion to "generally accepted accounting principles" include the modifying phrase "for independent schools."

This manual serves as a guide to interpreting generally accepted accounting principles for educational institutions as they apply to independent schools.

The audit and internal control

A sound system of internal control is necessary to ensure that the school carries out fully its stewardship responsibilities for the funds entrusted to it. A sound system of internal control also makes it easier to complete the annual audit in an orderly and timely fashion.

An adequate system of internal control involves a formal organization structure and the specific methods and procedures used by the school to safeguard its assets, to check the accuracy and reliability of its accounting data, to promote operational efficiency, and to encourage adherence to prescribed policies. The following elements are fundamental to a comprehensive system of internal control.

- A clear-cut plan that provides for definite placement of responsibility and for specific lines of authority
- Division of duties, wherever practicable, between authorization and record keeping, so that the activities of one employee act as a check on those of another
- Forms, documents, and procedures that provide for control and proper approvals
- Auditing for compliance with policies and procedures, particularly those relating to transactions reflected in the books and to reports based on such transactions

Internal controls are covered in Chapter 10.

Selecting a CPA

The school should keep three basic considerations in mind in selecting an independent auditor: quality of audit work, level of personal attention and service, and cost of service.

Quality of audit work

As far as quality is concerned, the school may assume that any certified public accountant is competent to provide accounting and auditing services that fully meet the standards of the profession. In evaluating the relative strengths of accounting firms, the school may solicit recommendations from the school's bankers, from trustees who are familiar with the local business community, and from other independent schools. Attorneys are also often able to recommend accounting firms with which they have worked in the community. It is also entirely appropriate to ask a CPA to give current clients as references.

Another favorable sign is a CPA who has other independent schools as clients. While this cannot always be the case, and is not a requirement, it is one good way of ensuring that the CPA is keeping up with school accounting and auditing issues.

Personal attention and service

The level of personal attention devoted to the school is not necessarily related to the size of the accounting firm. What is important is that the school is considered to be a significant client. Evidence that the school is a significant client includes continuity in staffing the engagement from year to year, sending in staff accountants who understand fund accounting, continuity in the engagement at the partner level, contact with the school initiated by the client partner at least once a year beyond the audit engagement, timely scheduling and expeditious completion of the annual audit, prompt delivery of the audit report, and annual submission by the firm of a meaningful management letter.

The advantages of dealing with a large accounting firm *can* be significant for many schools, in terms of more wide-ranging staff experience, access to national expertise in special problem areas, and widespread recognition that the audit work is of the highest quality. Nevertheless, some schools prefer to work with a smaller auditing firm because they feel that the level of personal attention and staff continuity is higher. This manual does not express a general preference for larger or smaller auditing firms. Whatever the size of the firm, the school should expect it to provide a high level of personal attention and service.

Cost of service

In selecting a CPA, cost is not necessarily the overriding criterion. Sometimes the CPA quotes a low fee because he or she does not plan to spend much time at the school. Sometimes the CPA quotes a low fee because he or she is more interested in the "contacts" represented by the school's board of trustees than in the school itself. And sometimes a low fee is quoted in the hope that the price can be raised substantially in later years, once a relationship has been established. It is also important to consider travel costs when evaluating the overall audit cost. Cost is an important factor, but it is only one of many aspects to be considered in selecting an auditor.

Cost is often negotiable within certain limits. It is not permissible to negotiate the scope of audit testing because this is determined by professional judgment. However, smaller accounting firms are often willing to work against an annual fixed fee based on their estimate of the time required to do the work. If their estimates prove inaccurate, the difference is reflected in setting the next year's fee, but not in extra charges for the current year. Large firms, on the other hand, usually have a policy of billing for actual time and charges. As a result, they often will not quote a fixed fee. In terms of eliminating the possibility of a significant budget variance, operating against a fixed fee can be an advantage to the school.

Working with the CPA

The agreement between the school and the CPA should be committed to writing each year in a formal "engagement letter," which is a statement by the CPA of the work to be performed by both the auditor and the school and of the cost of the auditor's services. The letter sets forth a general statement of the auditing procedures to be followed and describes the type of opinion that the auditor plans to render on the financial statements. It also describes the work the school must do to prepare for and help with the audit. The letter also usually describes some of the benefits the school should derive from the audit. Finally, the letter clarifies the responsibility the author takes for the detection of fraud. *Contrary to popular belief, an annual audit is not a guarantee against fraud. It is important that the trustees and the auditor have a common understanding of the role of the audit in fraud detection and prevention.*

7-8 • The CPA

It is important for the finance committee of the board of trustees to meet with the auditor once a year, usually following completion of the audit. At this meeting, the audit report is reviewed, the management letter is discussed, and the audit plan and fee for the following year are negotiated. If such a meeting is not held annually, the trustees are not deriving the full benefit of the audit.

The business office, as part of normal business procedures, should prepare as many of the audit workpapers as possible and also prepare a working draft of the financial statements. The audit will proceed much more quickly if the auditor can concentrate on reviewing and checking workpapers already prepared by school personnel than if he or she must first prepare the schedules and then audit them. Thus, failure to prepare these schedules can result in unwarranted excess cost of the audit. The auditor can specify what schedules are needed and how to construct them.

If the school prepares the draft financial report, rather than the auditor, it is also much more likely that the format will conform to the school's wishes (as long as this is within the purview of generally accepted accounting procedures) rather than to the auditor's wishes.

Auditing and accounting considerations are important in selecting an ending date for the school's fiscal year. Although the trustees may change the year-end date if there are strong reasons for doing so, June 30 is strongly recommended for the following reasons.

- The audit should be done as soon after the end of the school year as possible. Because of the extra work involved for the business office, the audit should also be scheduled to coincide with a slack period for the school. There is no more convenient time to undergo an audit in a school than July or August.
- Since the summer months also tend to be less busy for CPA's, they have more time to do an unhurried audit during July or August. Furthermore, the CPA is often willing to take on work in this lower summer season at rates below those charged in the peak winter season.
- It is convenient to have the end of the fiscal year coincide with a fiscal quarter as defined by federal tax legislation in terms of verifying payroll and tax information in connection with federal tax returns. June 30 ends a federal quarter, whereas July 1 starts a new quarter.

Whatever date is chosen, the fiscal year should definitely end in the summer (June, July, or August), after one academic year has ended and before the next one begins.

Changing CPA's

Periodic rotation of auditing firms as a policy is not recommended. As long as the school is satisfied with the service being rendered, the advantages of continuity and familiarity outweigh any potential disadvantages from loss of objectivity.

If the school feels that the present auditing firm is not providing good service, the business manager and finance committee chairman should discuss their concerns openly with the auditor. It is completely appropriate for the school to make its expectations known and then to hold the CPA to meeting them. If expectations continue not to be met, it is appropriate to change accounting firms.

The board of trustees must approve a change of auditing firms. If a change is made, the new auditing firm should be selected very early in the fiscal year so that the new firm will have ample time to plan for its first audit.

The new auditor will officially make contact with the prior auditor before accepting the engagement. This is a matter of standard practice among CPA's that does not imply a lack of trust on the part of the new CPA. The new auditor reviews the prior auditor's workpapers to help make a smooth transition in the changeover year.

7-10 • Exhibit 7-1

Exhibit 7-1

Sample Auditor's Opinion Letter

To the Board of Trustees of The Independent School:

We have audited the accompanying balance sheet of The Independent School as of June 30, 1990, and the related statements of changes in fund balances and current fund revenues and expenditures for the year then ended. We previously audited and reported upon the financial statements of The Independent School for the year ended June 30, 1989, which condensed statements are presented for comparative purposes only. Those financial statements are the responsibility of the school's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We have conducted our audit in accordance with generally accepted auditing standards. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosure in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The Independent School as of June 30, 1990, and the changes in fund balances and current fund revenues and expenditures for the year then ended in conformity with generally accepted accounting principles.

John Doe & Company

[City, state]

8.

Budgeting Concepts and Procedures

The annual operating budget of the school reflects the intersection of educational programs and school finances. It represents the most concrete reflection of institutional priorities. This chapter summarizes the basic issues, concepts, and procedures related to preparation and control of the operating budget. For a more extensive treatment of these issues in the context of not-for-profit organizations, see *Management Control in Nonprofit Organizations,* by Robert Anthony and David Young (Homewood, Ill.: Richard D. Irwin, 1984).

There is no more important management tool in an independent school than the budget for operating expenses and the related reporting of budgeted versus actual expenses. Properly used, this tool gives the school head leverage that will yield educational results well worth the time and effort invested. The budget is the financial embodiment of the annual planning process. Thus the real purpose of the budgeting process is to decide upon the operating plan for the year. Regardless of the level of financial stringency in the school, a thoughtful budget is essential to ensure that funds are used to achieve the highest possible level of educational effectiveness.

Stated most simply, a budget is an itemized estimate of inflows and outflows for a given period in the future. Obviously, such an estimate can cover a variety of periods and a variety of definitions of inflows and outflows. Here, our emphasis is on the *annual operating budget*. This emphasis focuses on revenues and expenses for the year. It excludes consideration of other kinds of budgets, such as the *long-range planning budget* (see Chapter

12), the *capital budget*, and the *cash budget* (see Chapter 9). The capital budget normally covers the same one-year period as the operating budget but concerns purchases of long-lived assets as described in Chapter 3.

Preparing the operating budget: timing

The "final" budget, the one against which actual results are measured, should be as accurate as possible. This tends to postpone to the latest possible date the setting of final budget figures. When a major item like tuition income is involved, the school cannot set a reasonably accurate figure until enrollment is complete. For some schools, this may mean April or May; for others, September. For all schools, however, the most accurate figure is one based on opening-day enrollment, since the presence of students confirms the commitments made earlier by parents and thus provides a final budget figure that cannot be challenged. For this reason, many schools approve the final version of their budget at the first meeting of the board of trustees after school opens in the fall.

No school waits until the year has begun to start preparing the budget. Starting the process earlier is required because the school must decide no later than midwinter about three of the largest items in the budget: tuition fees, financial aid, and faculty salaries. All of these decisions must be made long before the school year starts. Many heads begin their negotiations with teachers in January and hope to have faculty contracts settled by spring vacation. At that time, the enrollment and re-enrollment of students are at the decisive stage, making it necessary to announce tuition fees and financial aid levels for the coming year.

Moreover, these three items are closely linked by logic and necessity. Thus by February the school must determine three vital budget items: the largest item of income, and, typically, the two largest items of expense. With a little work, the school can, at the same time, make a reasonable estimate of the cost of many other items, from supplies and food to postage and telephone. The school should therefore adopt a "preliminary" budget at a midwinter meeting of the trustees.

If the school's management is to be ready by midwinter to make major decisions on tuition, financial aid, and faculty salaries, budget planning must begin no later than the fall term. Moreover, since a budget reflects the financial implications of educational policy decisions, it is necessary to begin the budgeting process early enough to capture the annual reconsideration of educational policies and programs that almost always starts as soon as the new school year begins. Educational planning for 1991-92 begins as soon as teachers and administrators begin the 1990-91 school year. The budget planning process for 1991-92 must therefore begin in the fall of 1990.

As long as it is clear that the budget must be tentative until much later in the year, the advantages of starting early far outweigh the corresponding loss in "accuracy."

Following is a chronological outline of recommended guidelines for preparing the annual budget. It need not be followed exactly so long as all the key steps are covered in sequence.

November. The head of the school asks each department head and other key administrators to propose preliminary budgets for their areas of responsibility for the coming year. It is necessary to make explicit the assumptions about enrollment that will underlie these proposals. These preliminary budgets are due in the head's office by the end of November. Specific dollar amounts are requested for all nonsalary items. For personnel, only a proposed staffing or "head count" level is needed.

December. Department heads and other key administrators discuss next year's expenditure requests with professional staff members in their departments, encouraging teachers to be creative and forward-thinking in proposing expenditures that will strengthen their areas within the school. Even though such "wish lists" probably cannot be fully funded each year, this process of determining ideal expenditure levels is a useful planning exercise. If professional staff members realize that such proposed expenditure lists represent goals to be worked toward over several years, rather than firm one-year requests, the process should continue to be meaningful each year.

In order to maintain a clear perspective about which expenditures are necessary in the short run, which ones are important but not critical, and which are most easily postponed, it is desirable to ask people who submit budget requests to rank proposed discretionary expenditures in order of priority.

Schools that give department heads a target dollar figure when asking for preliminary budgets have the advantage of making sure that the budgets submitted will realistically reflect what can be spent. The corresponding disadvantage is one of possibly constraining the professional staff unduly in its budget planning. It is generally true among independent schools that income rises over time to cover what are considered to be legitimate, necessary expenditures. To the extent that this is true, it is important that a certain amount of each year's educational planning take place unfettered by specific concern over how many dollars will be available next year.

In many respects, this issue of beginning the budget planning with or without specific dollar limits in mind is one of budgeting philosophy. Each school must think carefully about which path it wishes to follow.

January. Once the proposed departmental budgets are submitted, the business manager, with the guidance of the head, must pull all the pieces together to produce an overall preliminary budget. For items where variation is likely and is uncontrollable, it is important to budget conservatively. The business manager provides the necessary financial expertise to organize and tie together the bits and pieces into a coherent whole. *The ultimate responsibility for the budget rests with the head* because it represents the head's program.

A carefully conceived, fully descriptive chart of accounts is invaluable in providing meaningful past data for use in making reasonable budget projections.

The preliminary budget should be balanced so that projected revenues equal projected expenses. If a deficit is projected, some workable plan must be devised for finding the funds to cover it. If a surplus is projected, a plan must be made for the most useful deployment of excess resources. Once the head and the business manager have produced a preliminary budget that makes sense to them, it should be carefully reviewed with the finance committee of the board of trustees.

Once this committee approves the preliminary budget, it is good policy to have an approving vote by the entire board at a midwinter meeting, probably in late January. This vote needs to come early enough in the year for changes to be made, if necessary, in such key areas as proposed tuition levels, staffing levels, salary levels, and proposed financial aid allowances. Such decisions should not be locked in for the coming year without trustee approval. It is also important for the preliminary budget to be approved by the finance committee before the board as a whole is asked to vote on it. This will ensure, in almost all cases, that trustee approval is as routine as it should be when careful and prudent budget planning has preceded the request for an approving vote.

February. During this time, the head takes responsibility for reporting the decisions approved by the board, as reflected in the approved preliminary budget, to department heads and professional staff members. It is critically important that teachers and administrators understand why changes that have been made were necessary and that they accept the budget as realistic and fair, for they will have to live with it next year. Living with the budget can be very painful for all involved if people cannot accept it as a "consensus-oriented," "best possible" budget.

During this period, new tuition levels are announced to the public, faculty contracts are drawn, new salary levels are fixed, and financial aid guidelines for use by the admission office and financial aid committee are specified.

May to September. Final changes in the budget are made, based on additional information now available concerning enrollment levels, inflation rates, and educational program decisions. Any and all changes must be explained to the departments involved if they are to accept the changes as being legitimate. The finance committee of the board of trustees needs to approve the changes so that it may unanimously endorse the final budget to the entire board.

The board of trustees then makes the final decision on the budget, often as early as June. The trustees need to approve a preliminary budget before the end of the fiscal year so that necessary summer projects may be undertaken and so that commitments necessary for opening school in the fall may be made.

Incremental vs. zero-based budgeting

Several considerations are involved in projecting *next* year's revenue and expense: the budget for *this* year, the estimated results for *this* year, the actual results for *last* year, the operating plans for *next* year, and the forecast of two key variables—enrollment levels and inflation rates. A vital issue here is whether to use past data as a base for budgeting or to start entirely fresh each year.

A natural tendency is to take current spending levels as given and to concentrate only on proposed changes. This incremental approach usually results in devoting 85 to 90 percent of the time and effort to 15 to 10 percent of the dollars. A conceptually more appealing approach is to consider the justification for *each* dollar of expenditure *each* year. This process is called "zero-based" budgeting because it takes nothing as given. The base for a new budget is zero. Every dollar of expense must be defended anew each year. Zero-based budgeting is applied, at least in part, in both commercial and nonprofit organizations because it results in devoting the bulk of time and attention each year to the bulk of the dollars.

In practice, of course, it is not feasible to renounce all past commitments each year and start afresh. Past data are always of major importance to a new budget. As a concept, however, zero-based budgeting is sound. It should be kept firmly in mind each year lest past decisions be continually reaffirmed without full attention to their present applicability. One possible compromise is to schedule a detailed or zero-based review of some subset of budget items each year on a rotating basis. In this way, each item is reviewed carefully every few years. Even so, it should be kept in mind that past data may well be the most useful source of information on items that recur regularly from year to year.

For example, if the school has borrowed money, it will have to pay a predetermined amount of interest on the loan. Short of finding some way to pay off the debt ahead of schedule, the school has no choice about this expense. Almost as immutable are other items that have been programmed for a period of two or three years, such as an agreed-upon three-year schedule of premiums with a fire insurance company. Unless the situation changes markedly, this schedule fixes next year's expense.

Other items, such as postage used by the head's office, are almost as easy to predict. Recent experience, current plans, and a check on postal rates make it easy to set a reasonable budget figure for this item.

Budgeting for salary levels

Salaries can be grouped into three main categories for budget purposes: faculty, administration, and staff. This breakdown is useful because very different frameworks are usually used for these three categories.

Staff salaries generally follow local labor market trends. Staff salary planning is typically formal and is concerned with staying in line with the local job market.

Administrators' salaries are individually set by the head, based on a blend of subjective and objective factors. Comparative statistics from NAIS can be very useful in evaluating where the school stands in this area. Since so few people are involved and each position is unique in the context of the school, administrative salary planning is not usually subject to much formalization.

Faculty salaries deserve special reference when considering budgets. Financially, faculty salaries are the largest single expense item in the budget. In human terms, the faculty represents the heart of the school. Obviously, the quality of a school depends on its ability to attract and retain a first-class faculty. This ability depends, at least in part, on faculty salary levels. Our treatment of the subject here is quite limited. Only three questions are considered, all of them relating specifically to the budget-making process: (1) What are some administrative approaches to handling faculty salaries? (2) What role does the faculty itself play in the discussions? and (3) At what level and in what way do the trustees deal with the matter?

Practice differs widely on the first point. In some schools, the head negotiates privately with each teacher each year. This system allows maximum emphasis on rewarding merit, but it has the disadvantage of tempting the head to neglect the nondemanding teacher in favor of the hardened negotiator. At the other end of the spectrum is the system used in most public schools and some independent schools—the published salary scale, with pay based on level of education and length of experience. Properly administered, this system guarantees objectivity but makes it difficult to reward the kind of merit that reveals itself in superb teaching regardless of the amount of graduate work. Between these two extremes are all kinds of combinations, such as ranges of salaries for differing age groups and arrangements that allow teachers of differing degrees of merit to rise along one of two, three, or four different tracks.

The part that faculty members play, officially, in the annual discussion depends on what system the school uses. In schools that have a salary scale, a faculty committee is usually heavily involved in the annual modifications to the scale. Even when the head sets each salary each year, extensive indirect faculty involvement is encouraged through formal evaluation systems that document teaching effectiveness.

Long before discussing any teacher's salary with that teacher directly, the head, using the system in effect and all the information that he or she can gather, should have worked out a faculty salary proposal and calculated its total cost. The proposal should be discussed with the chair of the finance committee and with the president of the board. Often a percent increase is approved, which then leaves the head with the difficult job of spreading the approved increment across the faculty equitably. A better approach is to build up to the desired aggregate percent change by adding up the desired increases for individual faculty members. If the lowest salary, the highest salary, and the overall salary budget seem reasonable and feasible, the president and the finance and education committee chairs, with the active help of the head, steer the proposal through the education and finance committees to the entire board.

This summary answers in part the question how trustees deal each year with the matter of faculty salaries. They deal with it, officially, at the committee level and at the board level. However, it is important to note that they are dealing with policy and with financial *totals*, not with individual teachers. It would be completely out of order for a trustee to communicate with an individual teacher about that teacher's salary. If a teacher complains about his or her salary to a trustee, the trustee should refer the teacher to the head and notify the head of the complaint.

One important matter is sometimes lost in the flurry: the salary to be budgeted for the head of the school. The president of the board should confer with the head regularly once a year to review the state of the school and the strengths and weaknesses of its administration. When this review has been made, it is the president's duty, after conferring with at least the chairs of the education and finance committees, to decide on the head's salary for the coming year and to see that the figure becomes part of budget planning. This procedure does not necessarily rule out some bargaining and negotiation, but it at least saves the head the embarrassment of having to be the first one to propose a financial evaluation of his or her own work. Similarly, the president and the head should remember to take the initiative in dealing with the salary of the business manager and other senior administrators who report directly to the head.

Budgetary control: implementing the plan

Once the board has acted, the function of the budget changes. Up to this point, it has been a financial plan, subject to revision as the school gathers its facts and makes its decisions. Now the budget becomes a firm and detailed control mechanism. The board has authorized the administration to collect and spend some specified amounts of money in specified ways. The head carries full responsibility but promptly delegates parts of that responsibility to the business manager and to appropriate department heads. The trustees have, in effect, authorized each of these persons to spend within specified limits without further board action.

Although many people in our schools view the budget as solely a restrictive device, we need to emphasize its positive aspects as well. Making a budget is a shared, creative planning process. After its adoption, the budget clears the way for the administration and faculty to do their best educational work, free from daily worry about the level of financial support.

A good faculty and staff, under good leadership, will be eager to get on with the job.

Controlling • 8-9
Expense

Controlling expense

Once completed, the budget does set limits, and the head and the business manager must see that actual spending is within an acceptable range of these limits. This requires a formal review and follow-up system. In some areas, such as faculty salaries, the system runs itself. The business office makes monthly payments on the basis of previous agreements. Except in rare emergencies, the actual figure will correspond at year's end with the budget figure. Moreover, a competent department chair who knows how to keep records, how to plan for the whole year, and how to work with the members of the department needs little help from either the business manager or the head in controlling discretionary expenditures in the budget. The head of the school should, of course, be perfectly clear in notifying each department head about the nature of his or her budget responsibility and about the amount available for spending.

One major issue in monitoring departmental budgets is whether or not the cost center manager can reallocate line-by-line variances as long as the overall total is not exceeded. In some schools this is the case. As long as total departmental expense is in line with the budget, variations in individual line items, which almost always arise during the year, can be reallocated at the department head's discretion. In other schools, any favorable budget variances revert to the head's discretionary pool. This difference is one of philosophy that should be resolved explicitly in each school.

In controlling expenses, the head has the help of two standard operating procedures: (1) concentration of purchasing authority in the hands of one officer, normally the business manager, and (2) the monthly operating statement.

The desirability of the first procedure should be obvious, but some schools do not follow it. Centralized purchasing is no assurance in itself of efficient budget control, but it is an important first step. The business manager cannot accept purchase requisitions from everyone in the school. Each requisition must first have the approval of the department chair involved or the person to whom the head has delegated budget responsibility for that particular expense category—the librarian or the athletic director, for example. To expedite the process, the business manager may also delegate some purchasing authority to such persons as the director of food services, the bookstore manager, the purchasing agent, department heads, or the maintenance supervisor. Even when this is done, the business manager should review purchase requisitions as a control check.

The second important control procedure is the monthly operating statement. The format recommended below shows, in adjoining columns, the budget amount for the year, the actual expense this month, the actual expense for the year to date, year-to-date percent of budget total, last year year-to-date and percent of budget total, the latest estimate of actual expenditures for the year as a whole, based on experience to date, and the estimated variance for the year.

Many schools use a format that has columns showing actual for the month, actual for the year to date, budget for the month, and budget for the year to date. This approach is useful only if it is possible to develop budget figures meaningfully on a month-by-month basis. Dividing the annual budget by twelve to get a monthly budget cannot be relied upon to produce realistic month-by-month budgets, except for salary items. Because of the difficulty of breaking an annual budget allowance down into month-by-month increments, it is recommended that schools use the monthly reporting format shown below. There, the key variance for each expense item each month is the difference between the budget for the year and the latest estimate of actual for the year, based on the available information that accumulates month by month. Under this approach, month-to-month fluctuations in expenses are only important insofar as they indicate a change in estimated expenses for the year as a whole.

Here is the suggested format for the monthly operating budget.

	(1) *Annual budget*	(2) *Year-to-date expense*	(3) *Percent of budget*	(4) *Last year year-to-date expense*	(5) *Last year percent of budget*	(6) *Projected annualized variance*
Revenues						
Expenses						

In this format, column 6 is prepared by the business manager on the basis of judgment on the best current forecast of actual totals for the full year. Items where no change is projected from the original budget are left blank.

This format is intended for internal use by the business manager and the school head in controlling expenses month by month. Quarterly review by the finance committee can be facilitated by using a condensed version that shows only columns 1, 2, and 6. *Column 6 is really the only one of concern to the finance committee as the year unfolds.*

Interim • 8-11
Revision

Many different monthly reporting formats are used among independent schools, and many schools like the format they use. The key point is to follow up on variances as they develop in monthly reports rather than waiting until it is too late to take corrective action. So long as this is done, the particular format used is not of crucial importance. The report should be in the hands of the business manager, the head, and the other budget holders no later than ten working days after the end of each month in order to allow for corrective action before matters get out of hand.

Interim budget revision

Budget figures sometimes run over for reasons that cannot be foreseen or prevented. For example, a senior teacher falls ill, and the school must pay both the teacher and a substitute for five months. Or, because of an extremely severe winter, fuel costs exceed the budgeted amount. Or a few expenses decrease unexpectedly, and gift income exceeds expectations. Whether these changes balance out or not, there are two schools of thought about altering the budget. Should the trustees revise it three or four times a year, in line with most recent experience? *The board should be informed about changes as they occur and formally approve known important variations but let the budget as officially adopted remain unrevised for the operating year.*

It is important to keep track of actual results versus formally approved projections for the year even when subsequent events cause those projections no longer accurately to reflect current operations.

The budget and the monthly operating statement need to be presented in the same format so that ready comparison is possible. The audited annual report should also be presented in the same format so that budget and actual can be readily compared for the year as a whole. This point seems obvious, but many schools do not follow this procedure. *The benefits of ready comparison among the budget document, monthly operating statements, and the annual financial report should not be underestimated.*

Budgeting in perspective

A budget is a one-year plan carefully drawn to facilitate the efficient operation of the school. It should not assume other roles. Unfortunately, there are times when a budget seems almost to take on a life of its own. The comment is sometimes heard, for example, that "the budget won't allow us to do that," as if the budget were a miserly person lurking in the background of school life. "We failed to plan for that this year" would express this situation better, and these words would remind everyone who took part in preparing the budget that the job must be done better next time.

The same is true of budget control. If the entire faculty and administration have had a hand in making the budget, then everyone will know it for what it is and will help to keep it in proper perspective, because everyone will have a stake in making it work.

It is important to remember, however, that it is not the accuracy of the budget or even the processes by which it is developed that are of primary significance. Budgeting and accounting are not ends in themselves. They are only efficient means to an end, and that end is good education.

One last area of concern is the role of a "conservative bias" in budgeting. Prudence dictates being careful not to overestimate revenues or underestimate expenses. This means that a net surplus at the end of the year is a much more likely outcome than an exactly break-even result. Such conservatism is entirely appropriate. The net result is that funds are likely to be available for use outside the budgeting process. How such funds are allocated is an issue beyond the scope of this manual. It should be noted, however, that surpluses carried over from one year to another are not sacrosanct. They may be used as the trustees wish.

9.

Cash Management

The primary tool in effective cash management is a comprehensive, up-todate *cash budget*. A cash budget is different from an *operating budget*. The operating budget is a projection of the revenues the school will earn and the expenses it will incur during the year. Progress in meeting the operating budget is monitored throughout the year as part of the cost control process, but it really is the difference between revenues and expenses for the year as a whole that is important, not month-to-month differences.

The cash budget

The cash budget is a twelve-month projection of all cash receipts and cash disbursements for the school. It is important to keep in mind that cash receipts are not the same thing as revenues earned and that cash disbursements are not the same thing as expenses incurred. For example, some cash receipts this year do not represent earned revenue this year, as in the case of collection of prior years' tuition. Similarly, some of this year's revenue will not be collected in cash—tuition waived as financial aid, for example. Some cash disbursements do not represent operating expenses, as in the case of payments on mortgage principal. And some operating expenses do not represent a cash disbursement—financial aid, for example. The cash budget is therefore very different, conceptually, from the operating budget, though both are important management tools.

Since the school must maintain adequate cash balances at all times to pay bills as they fall due, cash receipts and disbursements must be monitored on a month-to-month basis. Thus, for the cash budget, month-to-month variations in cash inflows and outflows are equally as important as overall inflows and outflows for the year. As we indicate later in this chapter, most schools maintain a log of daily cash activity. Such a log is an essential tool of cash management. If the school has cash flow problems, careful projections on at least a monthly basis become a critical management tool.

Preparing a monthly cash budget is quite simple. First, total anticipated cash receipts for the year are projected by month. Then, total anticipated cash disbursements for the year are projected by month. Projected month-to-month fluctuations in the cash balance are then calculated, using a summary schedule such as the one shown in Exhibit 9-1, at the end of the chapter.

The next step is to consider how projected receipts might be accelerated or projected disbursements be postponed to avoid "red" balances in some months, to reduce the size of red balances wherever possible, or to increase the amount of excess cash, which can be invested temporarily. Red, or negative, cash balances in the projected cash budget indicate a need for short-term borrowing to finance the temporary deficit. While the timing of many receipt and disbursement items is not discretionary, other items do allow some flexibility in timing. Those items can be "managed" to produce a more advantageous overall cash flow picture.

Cash management program

An effective cash management program has three primary goals: (1) to get cash receipts as soon as possible, (2) to postpone cash disbursements as long as is prudent, and (3) to invest "excess" cash, while it is on hand, to earn a return. We consider each of these areas separately.

Cash collection policies and procedures

The primary source of cash for the independent school is tuition receipts. It is very important for the board of trustees to establish a policy ensuring that tuition will be collected as promptly as possible. Such a policy should cover the following issues.

How large an enrollment deposit is required, and when?

When will tuition bills be mailed?

When is tuition "due"?

When "must" tuition be paid?

Under what conditions is interest charged, and at what rate?

Who is responsible for following up on unpaid amounts between the "due" date and the "must be paid by" date?

What sanctions are applied if payment is not received?

It is absolutely essential that the school have a formal enrollment agreement, or contract, signed by parents that clearly spells out the full tuition policy in easily understood language.

The school's enrollment contract should accompany the letter of acceptance that goes to new students as well as the confirmation notice that is sent to returning students in the spring. Multiple copies may be prepared for the people who need them—the parent or guardian, the director of admission, and the business manager. In addition to reflecting the policies outlined above, the contract should include all of the following details.

Name and address of student offered admission

Space for parent or guardian to sign (accept) the enrollment contract

Consideration and details of payment (deposits, dates, amounts due)

Policy on withdrawal for various reasons and on tuition refund insurance; date and method of canceling contract without penalty (according to NAIS policy guidelines, given in Exhibit 9-5, each school should offer tuition refund insurance to parents who wish to purchase it)

Reference to rules contained in the school's catalogue

Statement (optional) that the school is nondiscriminatory (see IRS Revenue Procedure 75-50)

Space for the school to acknowledge acceptance of the signed contract

It is essential that the school work closely with its legal counsel to develop an enrollment agreement that is appropriate to its own circumstances. A sample enrollment contract, included as Exhibit 9-2, was developed with the assistance of A. W. G. Dewar, Inc., originators of the Tuition Refund Plan, and is reproduced here with their permission.

Regarding enrollment (and re-enrollment) deposits, the trend in most schools has been to move from a very small deposit to an amount ranging up to 10 to 15 percent of tuition. This larger deposit, which brings cash into the school to cover expenses during the summer months, may be applied in the following ways.

Applied to the first tuition payment

Applied to the second tuition payment

Split between the two payments

Held until year end to cover bills or re-enrollment

Some combination of these four

A further advantage of a larger deposit is that it encourges the family to be sure of its intention to enroll. This gives the school greater assurance in the spring about projected fall enrollment levels.

Recommended practice is to mail tuition bills no later than July 1. General practice regarding tuition due dates seems to be to require 50 to 60 percent before school opens and the remaining 50 to 40 percent before the end of December.

An increasing number of independent schools require that tuition be paid in full in August, which naturally gives the school much more advantageous cash flow. Parents have not raised major objections to this method, and it has had no noticeable negative effect on applications. In addition, having all tuition paid in August avoids disputes over contractual obligations in cases of withdrawal or dismissal during the school year.

Some schools have adopted a policy that provides full payment in advance for the school but allows parents to spread the cost over twelve monthly payments. The plan works as follows.

> The school arranges in advance with a local bank for a twelve-month installment loan program for parents who do not wish to pay the entire amount of tuition in advance.
>
> Such a loan is typically very easy to establish because the clientele of an independent school represents a "better than average" customer pool for the installment loan department of most banks.
>
> Once the plan is established, the school sends a twelve-month installment note along with each re-enrollment contract. The parent may either pay tuition in full or return the signed note.
>
> The school takes the signed note to the bank, which forwards the full amount of tuition to the school immediately and sends a coupon book to the parent. The parent thereby becomes a regular twelve-month installment loan customer of the bank.
>
> The parent makes monthly payments directly to the bank, allowing the school to avoid the bookkeeping expense of a monthly billing program.
>
> If payments are delinquent, the bank follows its normal collection procedures. Depending on the attitude of local banks about such loans, the school may be able to negotiate "non-recourse" acceptance by the bank of all such loans. Even if the school must guarantee loan losses, it is no worse off than it would be by carrying the

payments itself. In fact, the school is probably still better off, because the bank is likely to follow a more aggressive and persistent collection program than the school would.

The school should consider several banks before agreeing to guarantee loans. Banks expect some loan losses in the normal course of business, anyway, and the school's parent body should constitute a relatively low-risk pool. The school may also be able to negotiate a loan rate that is below the market rate because of providing a pool of desirable loan business to the bank.

If several schools in an area go together in developing and sponsoring a plan such as this, the group of schools should have even more leverage with local banks in negotiating a plan that is favorable to them and to parents. Such group plans are now in operation in several places in the country. Such group plans are now in operation in several places around the country.

A nonprofit organization, The Education Resources Institute (TERI), helps schools—and parents—develop installment payment plans. The organization's principal program is PLEASE (Parent Loans for Elementary and Secondary Education). Information about PLEASE is available through NAIS.

The school should have a stated policy regarding refund of tuition. A recommended guide is given here as Exhibit 9-5.

The head of the school should stay out of the collection process to avoid the strained relations with parents that would inevitably result. Follow-up on collections is best left to the business officer or to the treasurer of the board of trustees. A sample collection follow-up letter is shown as Exhibit 9-3. Although the school's business officer assumes primary responsibility for correspondence and other follow-up activities, the trustees must assume final responsibility for this troublesome but important area. If the school does not wish to handle such problems itself, it can call on the services of a collection agency or of an attorney who specializes in collecting unpaid bills. The school's banker should be able to recommend a reputable firm or attorney.

Some business managers find that membership in a credit bureau is helpful in assessing the credibility of parent promises when installment payments beyond the normal due date are requested. The credit report details the parents' payment history as a guide to their ability to make payments in the future. If a problem with their credit exists, the report reflects that. Many credit bureaus also have an affiliated collection service that may be helpful in collecting small outstanding balances at year end. The fact that nonpayment becomes a formal part of the credit record often encourages compliance. Credit bureaus are linked by a national credit network, making membership attractive to boarding schools as well as day schools.

Many schools charge interest on tuition that remains unpaid beyond the scheduled due date. Typical monthly rates of interest are 1 to 1-1/2 percent (for an annual rate of 12 to 18 percent). Allowing parents to extend payment of tuition in exchange for an interest "carrying" charge has both advantages and disadvantages. One advantage is more flexibility for parents in scheduling their tuition payments. Another advantage is additional income for the school. An annual return of 12 to 18 percent on uncollected tuition is usually more advantageous to the school than collecting tuition in full and then investing it temporarily. The principal disadvantage of deferred payment plans is the possibility of collection problems when payment is delayed too long. Allowing tuition payments to be extended beyond March or April is strongly discouraged.

If a school adopts the policy of charging interest on unpaid tuition, it becomes subject to the provisions of state or federal "truth in lending" legislation, which has three basic requirements.

- All persons must be treated alike, with no exceptions to the stated policy.
- All parents must receive formal advance notification of the policy, which can be included in the enrollment agreement.
- The annual interest charge must be clearly disclosed. This can be included in the enrollment agreement; it should also be covered in each tuition bill.

It is essential for the school's legal counsel to verify that the school's policies and practices regarding interest and penalty charges are in accordance with the provisions of all relevant regulation.

In summary, the board of trustees should establish a comprehensive policy regarding tuition billing and collection procedures, including sanctions to be applied in case of nonpayment. Once the policy is established, absolutely no exceptions to it should be made without formal approval by the board.

Cash disbursement policies and procedures

The business office should have a formal policy covering the issuance of checks. The policy should cover the following points.

Persons authorized to sign checks. It is desirable to have several people authorized to sign checks so that someone will always be available when a check must go out. Normally, the head, the business manager, the treasurer, and the assistant treasurer are authorized. It is good practice to require two signatures on checks above a set dollar amount.

Scheduled payment dates. In an efficiently managed business office, checks should be written only on specified days. It should not be necessary to write checks more frequently than once a week, or perhaps twice in high-activity schools. Issuing checks upon request or on a more frequent basis involves unnecessary bookkeeping expense. Also, bills should not be paid before they are due because this wastes cash that can otherwise be invested to earn a return for the school.

Purchase discounts. Whenever discounts are offered for prompt payment, the school should take advantage of them. The cost of missing purchase discounts is usually very high. For example, a 2 percent discount for payment within ten days on a normal thirty-day invoice is equal to a *36 percent annual interest charge* if it is not taken. If payment is not made by day 10, it must be taken by day 30. The 2 percent discount is thus offered in exchange for twenty days' use of the money. It is just about always cost effective to take purchase discounts even if money must be borrowed temporarily from a bank.

Investing excess cash

The business office should be aggressive in collecting tuition promptly and be conservative in disbursing cash. When it is, the cash balance of the school will be positive for most or even all of the year. Whenever the cash balance is positive, excess cash should be invested to earn a return.

Independent schools that have an effective cash management program should be able to earn interest income equal to roughly half of the prevailing short-term rate multiplied by net tuition revenue for the year. Thus, for a school with $2,000,000 in gross tuition and $300,000 in financial aid, if the prevailing short-term rate is 8 percent, interest income of $68,000 is reasonable. ($2,000,000 – $300,000 = $1,700,000 net tuition. Half of 8 percent is 4 percent. Four percent x $1,700,000 = $68,000.) This calculation must be reduced by any accumulated operating deficit. Such deficits are often mistakenly viewed as just "bookkeeping" entries. In fact, a carryover deficit is a direct reduction of cash available for investment. The impact on operations each year is equal to the deficit times the prevailing interest rate.

Although many options are available for investing temporary excess cash funds, the school should always choose those that carry a very low risk. Because the funds are only temporarily available and will be needed for operations later in the year, trading off a higher degree of risk for a higher expected return is not consistent with prudent financial management

The easiest low-risk investment option to administer is a daily money market fund. The Common Fund offers a money market fund that, because of its nonprofit status and superior portfolio manager selection, has outperformed most other major money market funds. If the funds can be committed for a definite period of time—sixty to ninety days, or longer—certificates of deposit or commercial paper may offer a slightly higher return than a money market fund. U.S. government treasury bills and "prime" or "A-rated" commercial paper issued by major corporations clearly qualify as low-risk investment opportunities. While a somewhat higher return can usually be earned on these debt instruments, larger amounts of money must be committed. Furthermore, extra administrative problems are connected with buying and selling these kinds of securities. For the majority of schools, the ease of a money market fund outweighs any potential gain that might be realized from buying and selling individual money market securities.

All major banks have cash management departments. The school could consider using the services of its bank in setting up a money market account. Using a money market fund represents a decision that professional investment managers can earn a better average return on the school's excess cash than can its business manager or the finance committee of the board, even after allowing for the management fees involved.

The board of trustees should review and approve the choice of an investment option for temporary excess cash. For most independent schools, a daily money market account is an attractive choice when a balance among convenience, administrative ease, and earned return is being sought.

The school's commercial bank should provide a monthly analysis of cash activity to facilitate review of cash management performance. An example of such a report is shown in Exhibit 9-4.

Short-term borrowing: the line of credit

At times during the year, the cash balance may be temporarily negative, or "in the red." This is not necessarily a sign of poor financial health. It simply reflects month-to-month imbalance in cash inflows and outflows.

When the cash balance starts to become negative, the school has to borrow funds temporarily until cash receipts again exceed disbursements. In most cases, the funds temporarily required are borrowed from the school's commercial bank. *Such borrowing should be planned well in advance and be covered by a formal line of credit agreement.* The careful consideration of a twelve-month cash budget should ensure that the school knows when it will need to borrow, how much it will need, and when it can repay the loan. Bankers are much more comfortable dealing with loan requests on this basis than they are with sudden requests triggered by the appearance of an overdraft where the potential borrower is not sure how large a loan will be needed or for how long.

A line of credit is an arrangement between a bank and a borrower (the school) specifying that loans up to a set maximum may be drawn down automatically by the borrower whenever needed. As loans are repaid, the unused credit line is again available. Sometimes banks charge a "commitment fee" for the right to have a line of credit, which might be 1/4 of 1 percent of the maximum line per year. Most independent schools that have a line of credit are not charged a commitment fee.

If a credit line is used, a desirable feature is daily unrestricted drawdown and repayment, with interest charged only on funds actually used. Some banks still require that transactions be recorded in thirty-, sixty-, or ninety-day increments, with separate notes for each borrowing. This practice should be avoided, if possible.

Another requirement imposed by some banks in connection with a line of credit is that the customer maintain average checking account balances equal to 15 or 20 percent of the credit line or average borrowings under the credit line. This "compensating balance" practice is a way of increasing the effective interest rate earned by the lender. For example, if cash balances must equal 20 percent of borrowed funds, the customer may use only 80 percent, or 4/5, of the borrowings. If 12 percent interest is charged on loans, the effective interest rate is really 12 percent x 5/4, or 15 percent. Since compensating balances are a form of interest surcharge, it is usually possible to negotiate a credit line without such a requirement when a "fair" interest rate is charged.

To know the true cost of a line of credit, the school should be aware of compensating balances, commitment fees, and restrictions concerning when funds may be repaid. It is desirable to consider more than one bank in negotiating a credit line because effective rates of interest and levels of service differ from bank to bank. In addition, the rates of most banks are negotiable. The trustees should assure themselves that the school is making as advantageous an arrangement as possible.

Monitoring daily cash bala

As a way of monitoring the cash p
when cash receipts and disburs
many schools keep a daily cash log
deposited in the bank, total amo
balance carried over to the next
recommended because it is valua
monitoring excess funds availabl

Managing petty cash funds

It works best for the school to use
cash funds. Under an imprest sys
as a petty cash fund. A cash fund
of a specific person designated a
paid out of the fund, voucher sli
amount and nature of the expend
any given time, the sum of cash
equal the imprest balance of the f
as an internal control check at an

When the cash balance falls to
petty cash fund be reimbursed
manager reviews the petty cash
bursement to make sure that all
vouchers are then canceled or m
reuse.

g daily cash balances

ionitoring the cash position of the school on a day-to-day basis eceipts and disbursements are summarized only monthly, keep a daily cash log. The log simply shows, for each day, cash the bank, total amount of checks written, and the new cash ed over to the next day. Keeping a record of this kind is d because it is valuable in planning cash disbursements and xcess funds available for investment.

petty cash funds

for the school to use an "imprest" system for managing petty nder an imprest system, a set amount of money is designated h fund. A cash fund in this amount is set up under the control person designated as custodian of the fund. As expenses are ne fund, voucher slips signed by recipients and showing the nature of the expenditure are maintained by the custodian. At ne, the sum of cash on hand and signed voucher slips must orest balance of the fund. In this way, the fund can be audited l control check at any time.

cash balance falls to a pre-set level, the custodian asks that the nd be reimbursed up to its imprest balance. The business iews the petty cash vouchers in conjunction with the reim- make sure that all expenditures have been appropriate. The then canceled or marked "paid" to avoid the possibility of

Exhibit 9-1

Monthly Cash Budget Schedule

	Jul	Aug	Sep. . . Apr	May	Jun
1. Cash receipts					
.					
.					
.					
2. Cash disbursements					
.					
.					
.					
3. Net change this month					
4. Beginning balance					
5. Ending balance					

Item 1 – item 2 = item 3

Item 3 + item 4 = item 5

Item 5 for one month becomes item 4 for the next month.

Exhibit 9-2

Sample Enrollment Contract

This sample enrollment contract contains a reference to a tuition refund plan.

XYZ School
Address
Telephone
Academic Year 19___–___

Reservation Enrollment Contract

I hereby accept the place at XYZ School reserved for [name of student] in the ___th grade for the school year beginning in September 19___.

1. Fees and payments

In consideration of the acceptance of this reservation by XYZ School, the undersigned agrees to pay the required fees specified below.

	Due date	*Amount*
Registration fee (nonrefundable)	April 10, 19___	$
First tuition payment	August 1, 19___	$
Second tuition payment	December 15, 19___	$___
Total		$

I understand that the above-listed fees do not include incidental expenses including, but not limited to, books and supplies. I further understand that I may cancel this contract in writing, without penalty (except forfeiture of the registration fee), on or before July 31, 19___.

2. Unconditional obligation

I understand that the overhead expenses of the school do not diminish with the departure of some students during the course of a year and that my obligation to pay the fees for the full academic year is unconditional after acceptance of this contract by XYZ School or August 1, 19___, whichever is later. I further understand that no portion of such fees so paid or outstanding will be refunded or canceled notwithstanding the absence, withdrawal, or dismissal of the above student.

I agree to pay, to the extent permitted by law, the school's expenses of enforcement and collection of the tuition, fees, and related expenses, including, without limitation, attorney's fees and costs.

3. Tuition refund plan

In view of the obligations contained herein, I understand that a tuition refund insurance plan will be made available to me when the "first tuition payment" is billed. This plan will give me an opportunity to insure fees (prepaid and unpaid due charges) in the event of absence or separation from the school according to the terms of the policy. Additionally, if I participate in the plan, I authorize the XYZ School to collect any claim payment to which I am entitled under the tuition refund plan and credit it to my account, paying any excess to me.

4. Rules and regulations

I agree to accept the rules and regulations adopted by XYZ School. I understand that the student's disregard of the rules and regulations of the school may be deemed sufficient cause for dismissal. Furthermore, I agree to the policy of the school that, until an account is paid in full to date, no student will be permitted to take examinations.

I agree that the student may participate in all school activities, including athletics, and any school-sponsored trip away from the campus unless the school receives written notice to the contrary.

Signature of parent or guardian
who is financially responsible for student

____

Date______________ Address______________________________

Accepted
XYZ School

Date______________ By______________________________

In order to reserve a place for your child in the 19___ – ___ academic year, the parent or guardian must sign this contract in triplicate and return all copies to the school, together with the registration fee, no later than May 1, 19___ . One copy of the contract will then be countersigned and returned by the school.

9-14 • *Exhibit 9-3*

Exhibit 9-3

Sample Collection Follow-Up Letter

XYZ School
Address
Telephone

Dear __________ :

Your account has a past due balance. We would appreciate your prompt attention to this matter. If there is a problem in making your account current, please get in touch with me.

The school's policy requires us to take the following actions.

1. Any account in arrears is charged 1.5 percent per month, or 18 percent per annum, on the outstanding balance.
2. Bookstore charging privileges are stopped for all accounts in arrears.
3. A student may not take any final examinations.
4. A student may not return to school after a vacation period.

If your payment has been sent, we thank you and ask you to disregard this letter.

Sincerely yours,

Business Manager

Balance on ____________ is $ ____________ .
[date]

Exhibit 9-4

Monthly Bank Account Analysis Statement

XYZ School

Date ____________
Account no. ____________
Branch ____________
Officer ____________

1. Balance summary for all accounts

Average ledger balance	34,357
Less average deposit	6,165
Equals average available balance	28,192
Less required reserves	3,383
Equals investable balance to support services	24,809
Less balance required to support services	24,378
Available to support other services	431

2. Activity summary for all accounts

	Volume or $ (*)	*Price per unit*	*Bal. required per unit*	*Balance required*
Zero balance account	1	10.0000	1,165.81	1,166
Deposit item return	5	1.0000	116.58	583
Wire transfer – out	6	6.0000	699.49	4,197
Wire transfer – in	3	2.5000	291.45	874
Fine sorting	423	.0150	1.75	740
ARP – other	10	1.0000	116.58	1,166
First 005000 checks	515	.1300	15.16	7,807
Deposits	26	.4000	46.63	1,212
Deposited items	482	.0600	6.99	3,369
Account maintenance	2	4.0000	466.33	932
Other charges	1			2,332
Total balance required to support services				24,378

3. Service charge computation for all accounts

Activity charges	209.12
Less investable balance earnings credit at .102933	212.80
Less prior earnings credit	1,148.69
Equals net earnings credit	1,152.37

4. Individual account listing

Accounts	*Ledger balance*	*Available balance*	*Investable balance*	*Balance required*	*Activity charges*
T 28 02247	34,457	28,192	24,809	11,125	95.46
T 28 02077	0	0	0	13,253	113.66
Total	34,357	28,192	24,809	24,378	209.12

Exhibit 9-5

Guidelines for Refund of Tuition

The following policy guidelines for refunding tuition were drawn up in November 1980 by the Business Services Committee of NAIS, which is indebted to the National Association of College and University Business Officers for sharing information on which these guidelines are based.

We recommend that NAIS member schools use these guidelines to evaluate and, where necessary, to modify current school policies and practices to meet the spirit and intention of the guidelines.

1. The trustees should review and approve all charge and refund policies. As matters of importance to students, parents, and the school, they merit the board's close attention.

2. The school should consider parents' views in establishing and amending charge and refund policies.

3. The school should publish a current schedule of all charges that describes each one and states refund policies. Parents have a right to full, accurate information on the amount and purpose of each charge as well as a statement of which charges are and are not refundable.

4. The school should state clearly in all published materials which charges are optional, differentiating them from those that are mandatory. The school should also state clearly whether a charge is optional for some students but not for others.

5. The school should clearly identify in all published materials those charges and deposits that are not refundable. In general, admission, application, laboratory, facility, and student activity fees fall into this category.

6. It is recommended that the school's stated policy for refund of tuition include the following provisions.

a. The tuition refund is published for and accepted in writing by parents. This requirement is commonly met through wording contained in the enrollment agreement.

b. The school will refund all of the tuition charge, less deposit fee, if written notification of withdrawal is made prior to a well-publicized date that falls on or before the first day of classes.

c. If school policy calls for collection of the full year's tuition from each family regardless of the reasons for withdrawal, tuition refund insurance will be offered to parents.

7. The school should pay or credit refunds promptly. "Promptly" here means allowing time to process a formal request for refund, time to process a check if one is required, and time for delivery by mail. If the school has a policy against refunding small amounts, this policy should be included in the published refund policy.

10.
Internal Controls

A sound system of internal control is necessary to ensure that the school carries out fully its stewardship responsibilities for the funds entrusted to it. Such a system also makes it easier to complete the annual audit in an orderly and timely fashion.

Effective internal accounting control is achieved through an integrated system of people, records, and procedures. Creating a control environment is often a process of education. It must be clear from the attitude of trustees and administrators that effective controls are a matter of high priority. The institution's staff must then be made to understand the importance and philosophy of internal accounting control before an effective system can be created and maintained.

An effective internal control structure

An adequate internal accounting control structure requires that the school use specific methods and procedures to safeguard its assets, to check the accuracy and reliability of its accounting data, to promote operational efficiency, and to encourage adherence to prescribed policies. We suggest

A clear-cut plan that provides for definite placement of responsibility and for specific lines of authority

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This chapter was prepared with the help and cooperation of Coopers & Lybrand, an international accounting and consulting firm that specializes in business and financial manant of colleges, universities, and independent schools.

Division of duties, wherever practicable, between authorization and record keeping so that the activities of one employee act as a check on those of another

Forms, documents, and procedures that provide for control and proper approvals

Monitoring for compliance with policies, procedures, and budgets

Periodic formal review of the control system and its effectiveness in relation to the ever-changing character of the organization and the environment

Control from the top

The board of trustees and the school's administrators have ultimate responsibility for the internal accounting control structure. This responsibility is particularly important to independent schools, where scarce resources often limit the extent of formal control systems. Management must have a clear understanding of responsibilities, monitor accounting records and procedures, and review overall operations.

Control objectives

Internal accounting control objectives include control over authorization of transactions, recording of transactions, access to assets, and asset accountability. Internal accounting controls should reflect the unique environment, attributes, and risks inherent in the operation of the school. Key control objectives for each major area of operation should be identified and set forth in writing. (See "The basic accounting control system," below.)

Segregation of duties

Segregation of duties is a fundamental component of a good internal accounting control structure. Independent schools often do not have sufficient personnel to achieve traditional segregation of duties. In such instances, active involvement of trustees and senior administrators in monitoring the course of activities and the flow of resources in and out of the school is essential. (See Exhibit 10-1, "General Guidance Concerning Segregation of Duties," at the end of this chapter.)

Organizational policies and procedures

The operating policies of the institution and the accounting procedures followed by the business office should be clearly communicated and, whenever possible, clearly documented. These policies and procedures should be organized and available to appropriate individuals and should serve as a guide for resolving operating and accounting questions.

Review of financial information

Periodically, reports should be prepared to summarize financial activity in each of the major areas of operation. The frequency of reports and the number of reports generated should depend on the nature and importance of each operational area and the relative cost of preparing such information. Each report should be designed with its users in mind, presenting information in ways they can understand. The following are characteristics of effective financial reports.

Analysis in simple, nontechnical language

Important trends and events highlighted

Clear, concise, appropriate data, including comparisons and expected results

Budgets are an integral part of an internal accounting control structure. Comparison of actual results with budget estimates allows the school to measure performance, track the flow of resources, and obtain advance warning of operational problems or weaknesses in the control structure.

Code of conduct and conflict of interest

The school may wish to develop a policy addressing the conduct expected of faculty and staff members in dealing with potential conflicts of interest. Such a policy could help avoid possible conflict of interest problems. It should be part of the school's charter or mission statement and personnel policies or faculty handbook. Topics covered may include

Disclosure of outside financial interests that could lead to conflict of interest (applicable to trustees as well as faculty and staff members)

Policy with respect to other employment or involvement in business activities

Use of school facilities or assets (automobiles, computers, telephones, maintenance shop) for nonschool purposes or abuses of travel and entertainment

Harassment, faculty or staff grievance procedures

Periodic self-reappraisal

Controls that work well today can quickly be made obsolete by change—by an increase or decrease in the size of the school's staff, by a switch in service bureaus, or when a new type of investment is made. Accordingly, the school may wish periodically to reassess its control through formal or informal assessments by its auditors. Some questions to ask are

Have changes occurred that may require new controls?

Are changes being contemplated that may require new controls?

Have "surprises" been encountered that could have been anticipated through better controls?

Have explanations of budget variances been confusing or contradictory?

Has the business office been overworked, increasing the possibility of mistakes or delays in processing information?

Have the auditors' recommendations for improving the school's control structure been carried out?

Control enhancements should be made only when the benefits to be derived outweigh the costs of implementing and maintaining them.

Internal control and the independent audit

The independent auditor will need to consider the internal control structure in relation to undertaking a financial statement audit. The auditor's principal objective in considering the internal control structure is to plan an effective and efficient audit. It is important to be aware that an audit is *not* designed to provide assurance on internal controls, and the operation of some or all of the controls may not be tested if the auditor does not plan to rely on such controls. Auditors generally communicate to management and trustees deficiencies in internal controls that come to their attention.

The American Institute of Certified Public Accountants has issued Statements on Auditing Standards Nos. 55 and 60, *Consideration of the Internal Control Structure in a Financial Statement Audit* and *Communication of Internal Control Structure Related Matters Noted in an Audit*. The first contains a useful discussion of the elements of an internal control structure, including the control environment, accounting systems and control procedures, and the auditor's process for considering such controls (effective for periods beginning January 1, 1990). The second defines "reportable conditions" and includes examples in an appendix. Auditors will be required to report such conditions to audit committees or boards of trustees if such conditions are observed in audits of financial statements for periods beginning on or after January 1, 1989.

The basic internal accounting control structure

A school's transactions typically fall into one of the following control categories.

1. Cash receipts
2. Cash disbursements
3. Payroll
4. Billing and receivables
5. Accounts payable and accrued liabilities
6. Inventory
7. Fixed assets
8. Grants, gifts, and bequests
9. Endowment and investment income
10. Loans

Certain fundamental *control objectives* and *control procedures* exist with respect to each area. The five control objectives are completeness of input, accuracy of input, authorization of transactions, completeness of updating, and accuracy of updating. Control procedures identify the specific controls related to an area.

Following are common control objectives and related control procedures for each of the categories named above. Exhibit 10-2 identifies conditions that lead to increased levels of risk in an academic environment. Exhibit 10-1 provides general guidance for segregation of duties.

1. Cash receipts

Control objective. To ensure that all cash for the school is received, promptly deposited, properly recorded, reconciled, and kept under adequate security

Control procedures

- Segregation of the receipt, processing, recording, and reconciliation functions
- Listing and restricted endorsement of checks upon receipt; use of prenumbered receipts with periodic review of used and unused numbers; distribution of copies of the check listing to the persons responsible for maintaining the general ledger and accounts receivable detail as well as for preparing the deposit slip and bank reconciliation
- Cash deposited intact and on a timely basis by an authorized person who is independent of the receiving and general ledger functions; duplicate deposit slips prepared and a receipted copy received from the bank
- Initial listing of cash receipts compared to the duplicate deposit slip; receipts summary prepared for use and then posted to the cash receipts journal by an authorized person who is independent of the receiving and cash processing functions
- Bank reconciliation prepared by an authorized person who is independent of the cash receiving, cash processing, and cash recording functions

2. Cash disbursements

Control objective. To ensure that cash for valid business purposes is disbursed only upon proper authorization of management and that all disbursements are properly recorded

Control procedures

- Segregation of the authorization, check signing, recording, and bank reconciliation functions
- Advance approval of all expenditures by authorized persons; adequate review of supporting documentation, including evidence of receipt of goods or services before checks are signed; disbursements made by prenumbered checks; record of cash disbursements kept by the person processing checks
- Checks over a certain amount signed by two authorized persons; sporadic comparison of check amounts with record of cash disbursements
- Record of cash disbursements initialed by the check signer and compared to the disbursement summary, which should be prepared by the check processor so that an authorized person who is independent of the

check processing, signing, and authorization functions can post to the cash disbursements journal

- Bank statements and canceled checks received directly by an authorized person who is independent of the cash authorization, check processing, and reconciliation functions

3. Payroll

Control objective. To ensure that payroll disbursements to bona fide employees are made only upon proper authorization of management, that payroll disbursements are properly recorded, and that related legal requirements, such as payroll tax deposits, are complied with

Control procedures

- Segregation of the personnel authorization; payroll preparation, approval, and check disbursement; record keeping; and bank reconciliation functions
- Employment changes (additions and terminations), salaries, wage rates, and payroll deductions authorized by proper nonaccounting personnel and files kept by an authorized person who is independent of the payroll processing function; establishment of policies and procedures for accounting for vacations, holidays, and sick leave
- Review and approval by authorized nonaccounting personnel of time and attendance records, including hours worked, overtime, and special benefits
- Safekeeping of the payroll register by the processor of payroll checks; review of the check register when checks are signed
- Maintenance of a separate imprest basis payroll bank account with a set maximum-dollar amount that can be drawn and that is periodically reconciled; disbursements made by prenumbered checks; checks signed by two authorized persons if over a certain amount; review and initialing of the payroll register by the check signer; comparison of the initialed payroll register to the payroll summary, which should be prepared by the payroll processor so that an authorized person who is independent of the payroll processing, check signing, and authorization functions can post to the general ledger
- Direct review and reconciliation of bank statements with the payroll register by an authorized person who is independent of the payroll processing, check signing, and authorization functions

4. Billing and receivables

Control objective. To ensure that all tuition charges, credits and adjustments, fees and other assessments, cash sales, and gifts and contributions are recorded and that receivables are reviewed for validity and collectability

Control procedures

- Segregation of the billing, record keeping, and cash processing functions
- Advance approval of billings by authorized persons; establishment and effective communication of authorized tuition costs to those responsible for billing; reconciliation of registrar's records to fees and amounts billed to students
- Prompt recording of billings in receivable records or maintenance of copies of billings in distinct open files; preparation and timely posting to the general ledger of control totals of billings; protection of accounts receivable records from destruction or alteration
- Timely recording of collections in receivable records or on copies of billings by an authorized person who is independent of the initial receipt of cash; adjustments to original billings approved by nonaccounting personnel; periodic billings for outstanding accounts
- Review of disputed accounts outstanding by an authorized person who is independent of the billing and receivable functions; write-off of uncollectable amounts approved by nonaccounting personnel

5. Accounts payable and accrued liabilities

Control objective. To ensure that all accounts payable and other liabilities are identified, are supported by appropriate documentation, and are recorded and paid on a timely basis

Control procedures

- Segregation of the authorization, processing, and payment functions
- Advance approval of all expenditures by authorized persons and review of all supporting documentation before payment
- Timely recording of all approved invoices in the accounts payable register to establish control for payment; maintenance of unpaid invoices in a centralized distinct unpaid open invoice file; regular comparisons of vendor statements with open invoice files; review and approval for payment of invoices from unfamiliar or unusual vendors by authorized persons who are independent of the invoice processing function

- Prompt recording of payments in the accounts payable register to avoid double payment; periodic reconciliation of the accounts payable register and list of unpaid invoices with the general ledger by an authorized person who is independent of the invoice processing function

6. Inventory

Control objective. To ensure that inventory is properly recorded, safeguarded, and accounted for

Control procedures

- Segregation of the purchasing, custodial, processing, and record keeping functions
- Establishment of inventory responsibility and maintenance of appropriate physical safeguards
- Timely recording of the receipt, transfer, and withdrawal of goods in inventory records and maintaining adequate records concerning quantity for the more important inventory items
- Periodic reconciliation of inventory records with the general ledger; periodic physical inventories taken by persons independent of custody and processing functions

7. Fixed assets

Control objective. To ensure that fixed assets are adequately safeguarded, properly recorded, and acquired and disposed of only upon proper authorization

Control procedures

- Segregation of the authorization, purchasing, custody, and record keeping functions
- Capitalization and depreciation policies established by the board of trustees
- Fixed asset purchases limited to those approved by the board; board approval of the sale, retirement, or abandonment of fixed assets
- Recording of land, buildings, equipment, fully depreciated fixed assets, and fixed assets not currently in use in a fixed assets ledger, including description, location, identification number, date of acquisition, and cost of each asset
- Periodic reconciliation of the fixed assets ledger with the general ledger by an authorized person who is independent of the recording and custody

functions; periodic independent appraisal of fixed assets for insurance purposes

• Maintenance of custodial accountability and physical safeguards by each unit of the organization that has responsibility for fixed assets; periodic physical inventory of fixed assets by authorized persons who are independent of recording and custody functions

8. Grants, gifts, and bequests

Control objective. To ensure that all grants, gifts, and bequests are received and properly recorded and that compliance with the terms of any related restrictions is adequately monitored

Control procedures

• Segregation of the receipt and recording of grants, gifts, and bequests from expenditure and monitoring of amounts expended

• Recording of the gift or award receipt by an authorized person who is independent of the cash receipts function

• Reconciliation on a regular basis between development office gift records and gifts recorded by the accounting department

9. Endowment and investment income

Control objective. To ensure that endowment assets are properly recorded, adequately safeguarded, and managed in accordance with any related restrictions and prudent investment management practices and that all investment income is promptly collected, deposited, and properly recorded

Control procedures

• Segregation of the receiving, recording, custody, transaction authorization, and performance monitoring functions

• Documentation of principal and investment income restrictions and endowment recorded in the investment ledger by an authorized person who is independent of initial receipt or custody of endowment securities; reconciliation of the investment ledger with the general ledger by an authorized person who is independent of the recording of endowment securities

• Endowment securities deposited with an independent custodian or in a bank safe deposit box, with access to the securities requiring the presence of at least two authorized persons and all visits being recorded

• Inquiring of the custodian about the controls in place over the school's securities, especially those the custodian does not physically hold

- Obtaining a report from the custodian's auditor concerning the custodian's internal controls and assuring that an appropriate custodian agreement is in place that makes clear what occurs in the event of losses
- Approval of security transactions, including purchases, sales, renewals, and exchanges by authorized nonaccounting personnel; reconciliation of investment trades and income information among the books of the school, the records of the custodian, and the records of the investment advisers, if applicable; periodic review of the valuation basis of securities
- Review of the disbursement of restricted investment income by appropriate nonaccounting personnel to determine whether this function is being carried out in conformity with donor- or board-imposed restrictions; review of the promptness and accuracy of investment income payments made by underlying companies and investment custodians
- Periodic review of the allocation formula and the computation and distribution of investment income and realized and unrealized gains and losses

10. Loans

Control objective. To ensure that loan funds are properly accounted for, disbursed only to eligible, authorized persons, and repaid when due

Control procedures

- Segregation of the authorization, disbursement, custody, recording, and collection functions
- Periodic review of disbursements to determine whether they are in conformity with the school's financial assistance policies, in compliance with restrictions on loan funds and programs, and used for designated purposes, not for such undesignated purposes as current operations
- Periodic review by an authorized person who is independent of the loan recording and receivable functions of loan receivables to determine whether they are properly analyzed for collectability and are properly aged; turning over delinquent loans to collection agencies, to prohibit loan delinquents from receiving new loans; limiting the write-offs of loan receivables to authorized nonaccounting personnel
- Computation of principal and interest repayment checked for accuracy

Exhibit 10-1

Risks in an Educational Environment

The following chart shows the responses a school can make to the financial pressures of inflation and reduced sources of funds and the risks connected to the various possible responses. This chart is adapted from Vincent M. O'Reilly, Murray B. Hirsch, Philip L. Defliese, and Henry R. Jaenicke, *Montgomery's Auditing*, 11th ed. (New York: Wiley, 1990, copyright © 1990 by Coopers & Lybrand United States), pp. 795-797, by permission of John Wiley & Sons, Inc.

Financial pressures	School responses	Potential risks
Inflation	Cutting costs	Reduced control structure policies and procedures because of cutbacks in administrative staff
		Incentives to postpone accounting recognition of liabilities
		Unauthorized appropriation of school assets by underpaid employees
		Use of restricted funds for expenses outside donor's original intent
	Retrenchment	Potential difficult judgments in the accounting treatment of excess facilities
		Potential liability for early retirement benefits
Reduced sources of funds	Aggressive investment strategies	Valuation of real estate and other investments for which market values may not be readily determinable
		Need to determine physical existence of borrowed or loaned securities by confirmation or observation
		Accounting for complex transactions such as income from options and mortgages with equity participation
	Creation of unrelated affiliates and other new revenue sources	Increased risk from operations outside management's traditional understanding and control
		Nonobservance of restrictions imposed by donors on use of funds
		Valuation of funds advanced under deferred giving programs
		Appraisal of value of gifts in kind
		Exposure to taxation of unrelated income

Financial pressures	**School responses**	**Potential risks**
	Interfund borrowings	Borrowing from restricted funds, possibly against donor's intent
		Possible use of inappropriate interest rate for interfund loans
		Possible nonpayment of interfund loans
		Inappropriate or illegal expenditures of endowment principal
	External debt	Possible noncompliance with covenants
		Responsibility to report to holders of publicly held debt
		Need to capitalize interest
Need to modernize facilities	Capital expenditures	Expenditures on new space while deferring maintenance on old space
		Assumption of role of general contractor without requisite expertise

Exhibit 10-2

General Guidance Concerning Segregation of Duties

The material in this exhibit is adapted from Philip L. Defliese, Henry R. Jaenicke, Jerry D. Sullivan, and Richard A. Gnospelius, *Montgomery's Auditing: College Version*, 10th ed. (New York: Wiley, 1984, copyright © 1984 by Coopers & Lybrand, United States), pp. 295-297, by permission of John Wiley & Sons, Inc.

The risks associated with inadequate segregation of duties vary according to the particular duties involved. However, the following general guidance is often applicable.

- *Situations in which individuals carrying out accounting procedures also have access to related assets do not necessarily give rise to an increased risk of accidental error in the performance of the accounting procedure, but these individuals may often be in a position to commit and conceal defalcations [misappropriations of funds].* For example, an individual who is responsible for both the receipt of customers' payments and their posting to the accounts receivable subsidiary ledger may be able to adjust the detail receivable records to conceal a misappropriation of remittances. The risk of this occurrence is, of course, directly affected by the nature and extent of the control procedures present.
- *The risk of defalcation is less than that above if the individuals who perform basic control procedures also have access to related assets but do not perform any accounting procedures subject to the controls.* Any significant defalcation should be detected by the individual performing the related accounting procedure. For example, if in the situation described above, the individual responsible for the receipt of remittances did not have access to the detail subsidiary records, but instead was responsible for reconciling the detail balances to the control account balance, detection of the misappropriation would be more likely. Of course, the risk of undetected defalcation increases if the individual performing the basic control has the ability to alter or destroy the related accounting records.
- *If an individual who carries out an accounting procedure also performs a basic control over that procedure (i.e., there is inadequate segregation of duties), the effect of the basic control is impaired because errors in the procedure may be repeated, or not detected, by the control.* If an individual makes errors in performing an accounting procedure as a result of carelessness or lack of understanding, it is likely that the performance of the related basic control procedure will be inadequate for similar reasons. Normally, lack of segregation of duties of this type does not increase the risk of defalcation, provided that the person exercising the control does not also have access to the related assets.

The effects of basic controls and segregation of duties on the risk of errors and defalcations in the accounting records when responsible individuals either do or do not have access to the accounting records and related assets are illustrated in the following example. Assume a situation in which a controller is determining how to segregate duties within the cash disbursements function between employees A and B to minimize the risks of errors and defalcations. The elements of the system to be segregated are

- Access to accounting records (the general ledger and detail accounts payable records)
- Access to assets (check signing authorization)
- Performance of an accounting procedure (recording of disbursements in the cash disbursements journal)
- Performance of a basic control (the bank reconciliation)

The following matrix summarizes the risks of errors and defalcations under eight different sets of conditions.

Exhibit 10-2 • 10-15

Risks of Errors and Defalcations under Varying Control Conditions

("A" and "B" are used to designate two employees—employee A and employee B.)

Condition (see notes below)	*Individuals with access to*		*Performs accounting procedure*	*Performs basic control*	*Risk of*	
	Accounting records	*Assets*			*Unintentional errors*	*Defalcations*
1	A	B	A	No basic control	High	Low
2	A	B	A	A	High	Low
3	A	A	A	A	High	High
4	A	A	A	B	Low	High
5	A & B	A	A	B	Low	Low
6	A	A	B	A	Low	High
7	A	B	A	B	Low	Low
8	A & B	A & B	A	B	Low	High

(1) Risk of errors is high because there is no basic control. Risk of defalcations is low since A has no access to cash.

(2) Risk of errors is still relatively high since there is no segregation between recording cash disbursement and reconciling the bank account. Risk of errors is less, however, than if no basic control exists.

(3) A's access to both cash and the related accounting records could allow adjustment of the cash and accounts payable records to conceal a defalcation. The risk of unintentional errors may be high because A may be less conscientious than an independent person would be in reviewing the work performed.

(4) Segregating the accounting procedure from the control procedure should facilitate detection of unintentional errors; however, a defalcation committed by A might go undetected since only A has access to the accounting records.

(5) B's access to the accounting records reduces the risk that a significant defalcation will not be detected.

(6) A's access to both cash and the related accounting records could allow adjustment of the cash and accounts payable records to conceal a defalcation.

(7) Segregation between accounting and basic control procedures decreases the risk of undetected errors; separation of access to assets from the related accounting records decreases the risk of a defalcation.

(8) The likelihood of a defalcation by B going undetected would depend on the extent of A's involvement with the accounting records.

Note. The above matrix is designed to depict the interrelationships of the factors discussed earlier and their effects on the *relative* risk of errors and defalcations in the accounting records. Note that there is some risk of error and defalcation in all accounting systems, regardless of the adequacy of internal controls.

11.

Endowment Management

While only a few independent schools have substantial endowments, many have some endowment funds, and all could possibly build endowments. Because the underlying policy questions are the same no matter how large or small an endowment may be, this chapter has broad applicability.

In structuring a program to manage an endowment, it is important to define roles and responsibilities clearly. The school's board of trustees is responsible for establishing overall policy and overseeing its implementation. The finance committee of the board, with staff support, is responsible for the broad implementation of policy. The investment managers are responsible for the day-to-day management of portfolios.

A useful analogy to managing an endowment is building a house. The owners (the board) decide what kind of house they want. The architect (the finance committee and staff) takes the owner's requirements and develops detailed building plans. Finally, plumbers, carpenters, electricians, and others (investment managers) actually put the house together. Just as the construction of a house requires regular contact among owners, architect, and contractors, so the successful management of an endowment requires regular interaction among board, finance committee, staff, and investment managers.

This chapter was prepared with the help and cooperation of The Common Fund, a nonprofit membership corporation organized and operated by and for its member colleges, universities, and independent schools.

Setting policy

The two factors having the greatest impact on the long-term results of an endowment are its spending rate and its asset allocation. Over the long term, an endowment cannot maintain its real (inflation-adjusted) value, much less grow, if spending exceeds the real long-term rate of return of the endowment. The real rate of return over the long term is largely determined by the asset mix—that is, the percent invested in stocks, bonds, and other asset classes.

Because these two factors are so critical, they should be the focus of the board's attention. Since many board members do not have extensive investment backgrounds, the staff, perhaps with the help of consultants, needs to supply the necessary data on which to base decisions.

Asset allocation

Capital market history tells us that over the long term certain asset classes have higher returns than others. Unfortunately, that history also tells us that higher return is associated with higher volatility, particularly over shorter periods of time. Thus, trade-offs have to be made between the returns sought and the risks that can be run. The trade-off for one school need not and probably should not be the same as for another.

In general terms, to maintain an endowment's total value, an asset mix of between 60 and 70 percent equities coupled with a spending rate of between 5 and 6 percent is needed. Such a structure has produced good long-term results and gives promise of continuing to do so. Over shorter periods of time, including the 1930's and the early 1970's, bear markets have led to declines that have taken several years to recover from. It was almost impossible to maintain real value during the high inflation this country experienced in the late 1970's and early 1980's.

As a practical matter, boards are faced with the job of establishing endowment policies for a future that may well turn out differently from what they anticipate. While this problem cannot be eliminated, its magnitude can be reduced. Diversification among asset classes is perhaps the best way of controlling risk. Because various asset classes behave differently in different economic environments, using a variety of asset classes will reduce the overall volatility of the portfolio, even when the asset class added is, by itself, very volatile. The risk of an all-stock portfolio can be reduced by adding bonds, reduced further by adding non–U.S. stocks and bonds, and reduced further still by adding real estate, venture capital, and various types of private placements.

In deciding on an asset allocation policy, a board should consider as broad a range of asset types as possible and focus on the contribution each can be expected to make to the total portfolio over the long term.

Spending

Spending policy is the second major determinant of long-term results. Whatever the details of the policy, the board should recognize that spending more than about 5 percent of the current market value of the endowment usually results in a decline in the inflation-adjusted level of spending. In other words, the real level of support for the school may well decline if spending is too high.

The historic spending rule has been that income (interest and dividends) is all that may be spent. Many gifts and bequests contain provisions limiting spending to income. State laws on the subject vary. Local law and the terms of gifts and bequests should be reviewed by counsel prior to the adoption of a spending policy to ensure compliance with all restrictions.

Since dividend and interest payments tend to be fairly stable, an income-only policy has the advantage of producing reasonably predictable cash flows. While a stable cash flow is a definite advantage for budgeting and long-term planning, increases in income tend to lag in periods of high inflation, which can aggravate cost pressures. A more generic problem with an income-only policy is that spending needs, particularly short-term needs, tend to dictate the asset allocation. Thus the asset mix can move away from the one selected to provide the best trade-off between long-term return and volatility. Such moves are almost always in the direction of lower returns.

In recent years, many educational institutions have adopted spending policies that are tied to a percentage of the endowment's market value. Where legally permissible, this approach avoids the problem that arises when spending determines asset allocation, since funds can come from income or principal. There can be problems in the short-term management of the portfolio if spending exceeds income by a significant margin and securities have to be sold at depressed prices to raise cash. Tying spending to market values introduces a significant level of volatility into the amounts spent from year to year. While this volatility can be alleviated by using three- or five-year moving averages, the approach involved is less stable than an income-only rule.

A third approach to spending policy is to have spending grow by a specified percentage (approximately equal to the long-term inflation rate) each year. This ensures that spending will rise more or less in step with inflation. Schools opting for this approach should, however, be sure that the spending base amount is around 5 percent of the market value at the time the policy is implemented. Otherwise, spending will get ahead of asset growth, pushing the effective spending rate too high. It is advisable to cap spending so that it does not exceed 6 percent of the market value. A floor of 4 percent of market is also a good idea. Hitting the ceiling in a prolonged bear market could mean a period of no growth in spending.

An almost infinite number of variations on these three basic alternatives are possible. The policy the school selects will depend on the balance it strikes among the competing needs for income stability, income growth, and long-term asset growth. A complicated policy may appear to solve all problems, but it runs the risk of being hard to implement. This could result in the board making a series of ad hoc adjustments, which would effectively cancel the policy.

Implementation

Once broad policy decisions have been made, the school begins the implementation process. Here the objective is to achieve satisfactory returns while controlling volatility. Again, diversification plays an important role. In the stock portion of the endowment, for example, a combination of growth and value is likely to be more satisfactory over the long term than just one or the other.

A large number of approaches may be used in investing in stocks, bonds, and other asset classes. Several should be incorporated into the school's investment program.

Manager selection

The final step is selecting the firms that will actually manage the endowment. It is almost always preferable for a school to delegate actual portfolio management to outside firms rather than having staff or board members do it. Usually, neither board nor staff has the time or the specialized expertise to do the job effectively.

To obtain diversification in manager styles, most schools will find it best to use investment pools. These include mutual funds and The Common Fund, which provides independent schools with a range of investment funds and ancillary services.

For those who decide to retain individual investment managers, the selection process should be disciplined with clear selection criteria. While important, historic performance data are not the only criterion. It is equally important to understand the investment strategy and philosophy that produced the numbers. Consistency in approach is necessary. Also to be evaluated are the experience of an investment firm's principals, its ownership structure, its business plan, and turnover among key employees.

Fees are an important but secondary consideration in hiring managers. While schools must be prudent in deciding what to pay managers, there is no justification for hiring a weak candidate because that firm charges less. Put differently, it is worth paying extra to get a firm that can provide substantial incremental returns.

In recent years, various incentive fee arrangements have been developed. Essentially, these arrangements provide for a relatively low base rate and additional compensation if the manager's returns over an agreed period exceed a predetermined benchmark. While incentive fees have much to commend them, schools should be cautious in using them. One potential pitfall is choosing an inappropriate benchmark. Specialized managers should have customized benchmarks rather than using a broad market index. Otherwise, the manager will be rewarded (or penalized) as his or her style moves ahead of (or lags behind) the market rather than for skill.

It is also important to establish an appropriate measurement period. A moving three-year period is generally long enough to produce results that fairly reflect the manager's performance in a variety of market environments.

Monitoring and changing managers

Once the managers have been selected and are managing portfolios, the monitoring process begins. Regular performance reports should be required along with sufficient other data to ensure that the managers are continuing to do what they were hired for. Managers should inform the school promptly when key people join or leave the firm and let it know of other important developments as well.

In reviewing managers' performance, the school should remember that its endowment is a long-term investment. Short-term results should therefore not be overemphasized. Assuming that managers have been retained because of their differing strategies, they should not be compared with one another. Rather, each should be looked at in relation to the results of his or her approach. A manager of small stocks will (and should) lag when those stocks are doing poorly in relation to the broad market.

Written reports are all very well, but personal contact with managers is also needed on a regular basis. Meetings should be frequent enough to ensure that both school and managers continue to understand each other but not so frequent that they impinge on the managers' ability to run the portfolio. As a general rule, longer sessions at less frequent intervals tend to be more productive for all parties than short, frequent, routine reports. The meeting schedule will vary from quarterly to annual, depending on the board, the managers, and the particular investment approach involved.

It is, unfortunately, necessary to replace managers from time to time. Because changing managers involves substantial direct and indirect costs, this should be done only when necessary. On the other hand, it does not make sense to keep an unsatisfactory manager in the hope that things will improve during the next quarter.

12.
Financial Planning

Planning is integral to the management of any organization. All managers must consider the future implications of their current actions and must also evaluate possible future alternatives. When a multi-year time span is adopted and the financial aspects of such planning activities are emphasized as a major organizing theme, the result is called "financial planning." The subject of this chapter is *formal* financial planning, in which the process is made an explicit, required aspect of the management of the school.

As recently as thirty years ago, few independent schools or commercial enterprises engaged in formal financial planning. Most such planning was informal, irregular, ad hoc, or implicit. Today, most major commercial enterprises engage in formal financial planning, but it still is not widespread among independent schools. Perhaps one school in three is now doing this kind of planning on a regular basis.

The reasons for formal financial planning among business firms are applicable to independent schools.

- Many aspects of school operations cannot be seen as variable when only looking forward one year at a time. Examples include the profile of the faculty or student body, the basic organization of the administrative staff, and the direction of the curriculum. It is necessary to look forward far enough so that these factors are not immutable "givens" if the school really wants to consider the implications of changing them.
- Often what appears to be the rational or "best" course of action in dealing with some problems is different when considering its implications three to five years from now. For example, replacing a retiring German teacher with another German teacher might not seem so logical if course registration trends indicate a significant reduction in German enrollments

over the next few years. Formal planning facilitates careful consideration of the future implications of those decisions that need to be made today.

• Many small day-to-day decisions are made each year by school administrators without much careful "intellectualization" and without much formal analysis. Even though such decisions do not mean a great deal, individually, to the school as a whole, their cumulative impact over time can be significant. Many organizations have found that the exercise of formal financial planning creates a much more highly future-oriented attitude among senior administrators, which translates into better "reflex decision making" from day to day. This same phenomenon should apply to independent schools as well.

As Abraham Lincoln once noted, "If we could first know where we are and whither we are tending, we could better judge what to do and how to do it." *All independent schools should begin formal financial planning.* The remainder of this chapter is devoted to how this can be accomplished.

Decomposing the cost structure for planning purposes

It is useful to break the budget down into five major categories for planning purposes. In boarding schools, a sixth category is added. Such a breakdown is useful because the method of analysis and frame of reference are different in tackling each of these six segments. The suggested categories are

Instructional expenditures. All expenses classified as "instruction" in Chapter 5.

Administrative expenditures. All expenses classifed as "general" and "administrative" in Chapter 5.

Plant-related expenditures. All expenses classifed as "operation and maintenance of plant" in Chapter 5.

Auxiliary services. All expenses classifed under the same caption in Chapter 5.

Financial aid expense. As discussed in Chapter 4.

Boarding services. The sixth category, for boarding schools, includes expenses for the dining hall, the health service, the laundry, and housekeeping expenses in the dormitories.

Instructional expenditures

The major cost of the instructional program is faculty compensation, which is the result of the interaction of the following factors.

Student enrollment

Student workload. How many courses does a student take, and how many periods per week do these courses meet?

Course offerings. How many separate courses and multiple sections does the school offer?

Faculty workload. How many courses does a teacher teach, and how many periods per week do these courses meet?

Size of the faculty. Measured in full-time equivalents.

Average class size (and variability around the average)

Faculty salary levels

Employee benefits package for faculty members

The first step in making a financial plan is to consider specifically where the school stands now on each of these "cost causing" factors. Each of them represents a *variable* that can be changed if the school decides to do so. None of them is immutable. Furthermore, current practices among independent schools vary across a significant range on all of them.

For example, employee benefits for faculty members normally include FICA and some form of supplemental retirement program, such as TIAA/CREF, plus at least a portion of the premium for hospital and physician's insurance. They usually, but not always, also include group life insurance, disability insurance, and full or partial tuition remission. They sometimes also include premiums on dental or vision insurance, payment of education expenses, and sabbatical leave plans. Overall, the range is broad. Excluding the value of live-in perquisites, such as food, housing, and use of the health services, the employee benefits package among independent schools ranges from 10 percent of cash salaries to over 25 percent. The benefits package clearly represents a planning variable on which schools differ widely. Basically, the same is true for all the other factors listed above, as well.

The first six items on that list should be analyzed at the departmental level, in schools that are organized by academic departments, to highlight differences among academic units that would be buried in overall school averages.

Nonsalary instruction expense includes books and materials, departmental expense, extracurricular activities, curricular equipment and supplies, and library expense. In aggregate, on a per student basis, these expenses do not vary widely from school to school. The range in day schools was typically from about $300 per student to around $500 in 1990. Because this range is so tight, such expenses really are not a major planning variable. Budgetary control is important, but explicit attention in the planning process is not.

A specific, quantitative analysis of these factors is beyond the scope of this manual. Each of them does play an important part in the cost structure of the school, however, and each one should be analyzed separately in determining why the school's instructional programs cost what they do.

Administrative expenditures

The key to analyzing administrative expenses is a comprehensive organization chart for the school, showing how the various administrative functions of the school are grouped, who is responsible for them, how many support (clerical and secretarial) personnel are assigned to each, and how much each administrator and support staff person is paid.

In an independent day school, the following functions must be covered by someone: admission, business office, dean of faculty, dean of students, and development/alumni(ae) affairs. In a boarding school, residence halls and food service typically also require a full-time senior-level administrator. College counseling is also a critical function in all independent secondary schools today. The function clearly requires a trained professional person. But, because college counseling involves direct contact with students, it is considered instruction expense under the philosophy explained in Chapter 5.

NAIS statistics can be helpful in comparing administrative costs, as well as other costs, across independent schools. NAIS publishes statistics twice a year that are based on information submitted by member schools. The fall report summarizes tuition fees, faculty salaries, and administrative salaries for the current school year. The spring report summarizes information for the current school year in the areas of enrollment, staffing, people of color, and financial aid. That report also presents financial operations and annual giving information for the prior school year.

Upon request, for a small fee, NAIS will prepare special summaries of any subset of this information for an individual school. At least five schools must be aggregated to protect the anonymity of individual schools. The purchaser may specify the set of schools, but the figures used in the study are not identified with the individual schools.

Plant-related expenditures

A key factor in analyzing and controlling plant-related expenditures is the level of investment in plant assets. The level of investment per student varies dramatically among independent schools. The range, stated in terms of replacement value in 1990 dollars, is less than $4,000 per student to over $30,000 per student for day schools, and from less than $20,000 per student to over $100,000 per student for boarding schools. Since the annual cost for utilities, insurance, maintenance, janitorial services, and average renewal outlays seldom runs less than 6 to 8 percent of plant value, this means a range of annual plant cost from around $250 per student to well over $2,000 per student, just among day schools.

Unfortunately, comparative figures for maintenance and utilities and janitorial cost per square foot, per dollar of plant value, and per student are not available across independent schools. This is an area in which much progress is needed. The task is made much more complex because of the variability in costs induced by wide-ranging climate conditions, different mixes of fuels used, differing types of plant construction, and varying ages of plant assets.

It is almost a truism that a school always "needs" more plant than it has. Every school has a list of "necessary" plant expansion projects that are waiting for additional funding. While it is also true that not many independent schools have been driven to bankruptcy because of too much plant, the burden of carrying the plant each year does impinge much more heavily on some schools than on others. The level of investment in plant assets cannot be changed dramatically in the short run. However, careful attention to how much plant the school can really afford and to whether future plans should realistically involve plant expansion, contraction, or significant redeployment represents a major aspect of effective financial planning. It is also good policy to plan for an endowment equal to one third the cost of new construction to provide for maintenance on that addition. To a large extent, the level, type, and age of plant assets determine the annual cost of operation and maintenance of plant.

Specific considerations of norms or guidelines for various plant-related cost items is beyond the scope of this manual.

Auxiliary services and boarding expenditures

The key to analyzing auxiliary services and boarding expenditures is to determine what level of service really needs to be provided. Just because the school has always provided a hot lunch program and door-to-door busing does not mean that it necessarily must do so in the future. The category of food service offers many examples of successful day schools at each of the following levels of commitment.

Hot lunch served family style in a dining room

Hot lunch provided cafeteria style in a lunchroom

Food machines (and brownbag lunches), with a lunchroom provided

Lunchroom available, but only beverage machines provided

Lunchroom provided, with no vending equipment or support personnel

Students eat brownbag lunches in their classrooms

Students go home for lunch

The costs of these options vary tremendously. A similar set of options exists for transportation of students in a day school. In a boarding school, widely varying levels of commitment are possible for health services, laundry, housekeeping services, and the student store.

The main point here is that cost analysis for such services begins with an analysis of the appropriateness of the level of each service being provided. Assuming that the current level of service is being offered in the most cost-effective way, can the school afford to do it? Alternatively, from a policy point of view, can the school afford not to do it? Once this basic issue is resolved for the time period being studied, good comparative data exist for what it should cost, per student, to provide that level of service. Evaluating cost effectiveness at the level of service deemed appropriate is an important but less troublesome planning problem.

Financial aid expense

From a planning perspective, the relevant questions to ask about financial aid are why it is being offered and how large the commitment is. Reasons for financial aid cluster around three possibilities.

- As a way of providing an economically diverse student body
- As a way of attracting outstanding scholars, athletes, artists, or leaders who otherwise would not attend the school

- As a way of including children from families who otherwise would find it financially difficult to enroll

Many schools are now using loans as part of their overall aid package. It is important to make explicit the reasons for financial aid so that the success of the program in meeting its goals can be assessed.

The level of commitment to financial aid is measured in different ways.

Number of financial aid grants

Percent of student body receiving aid

Average grant in dollars

Percent of tuition awarded as aid

Percent of overall expenses represented by financial aid

The critical measure in assessing the level of commitment is how nearly the aid package meets the calculated need of the family. An average grant of $5,000 sounds large, but with a $15,000 boarding school tuition the family must have the ability to pay $10,000, which would deny access to most middle income families. Conversely, an average grant of $3,000 does not sound large, but if tuition is only $5,000 the family only needs to raise $2,000.

Thus the *proportion* of aid granted to a family is what determines how much "access" the school really provides. This number subtracted from average tuition is the required level of financial aid. This amount times the target number of students receiving financial aid is the aggregate financial aid commitment for planning purposes.

The appropriation for financial aid is ordinarily the next largest expense after faculty compensation in the budget. Determination of financial need and the calculation of aid should be performed by an individual who through training and experience has demonstrated proficiency in the reading and analysis of financial statements. The growing use by parents of tax professionals to prepare income tax returns requires the financial aid officer to bring equally professional skills to the job at hand. Increasingly, schools are turning to the business office for help with this complex job.

Overview

This discussion of the principal components of the operating budget has focused on analyzing major factors affecting the level of expenditures. This analysis of why the school is spending what it does is the first phase of comprehensive financial planning for the school. This phase involves three distinct steps: (1) analyze current spending levels, (2) compare with past trends and/or with similar schools, and (3) evaluate specific strengths and weaknesses.

The process starts with outflows rather than inflows because, in principle, revenues rise to cover the expenses that are necessary to provide the desired educational program. This principle cannot be as readily applied in annual budgeting, but it is fundamental to meaningful long-range planning. The history of independent education reveals the validity of the principle when sufficiently long time periods are observed.

The financial planning process: an overview

Here in sequential outline form are the six steps involved in putting together a financial plan for the school.

1. *Analyze the current cost situation.* For each of the major components of the operating budget, analyze the current primary "cost-causing factors" as described under "Decomposing the cost structure," above.

2. *Project the cost structure forward.* Taking into consideration any specific changes that are deemed appropriate in the various "cost-causing factors" as well as projected inflation rates and unavoidable cost changes, project the cost structure forward over the time span selected for the financial plan. When these projections are pulled together for all major components of the budget, the result is a preliminary comprehensive year-by-year expenditure plan.

Projected enrollment is obviously a critical variable at this step because many expenditures will vary depending on the number of students enrolled. There are two basic approaches to projecting enrollment. In a full school, the approach is to fix the allowable upper limit as a policy variable. The admission process then works down to this number. In schools that are not full, the approach is to project enrollment based on an evaluation of all the market forces that shape "demand" for the school's services. An active, broad-scale marketing program is critical in generating applicants of high quality. One outcome of the marketing program should be a realistic enrollment forecast.

3. *Project nontuition revenues.* Using the same time span, project expected nontuition revenues—gifts, dividends and interest, miscellaneous fees, and other income. An item that can be significant here is income from use of the school in the summer for a camp, a summer program, or conferences. This

is an excellent way to use otherwise idle facilities to offset operating expenses. Schools are encouraged to be aggressive in this area.

4. *Compare steps 2 and 3.* The difference between projected cost outlays and projected nontuition revenues each year is the amount required to be raised through tuition. When divided by total enrollment, this becomes the preliminary planned tuition figure per student. Of course, different tuition rates may be projected at different grade levels or for boarding versus day students, if both are present.

The trend in recent years has been toward less variability across grade levels in tuition charges in day schools. There is substantial evidence that lower grade levels are not less costly to operate than upper grade levels. Cost analysis thus usually supports a very flat tuition scale. There is also substantial evidence that family incomes are not appreciably lower for lower school families than for upper school families, as a rule. This contradicts a supposition used in the past to justify lower tuition charges in lower grades. If lower grades are not less costly and lower school families are not less financially able, the only remaining argument for steeply scaled tuitions is marketing strategy—the loss leader concept. Very few schools would openly espouse such a pricing policy. So, unless the school has a conscious policy of underpricing the early grades, one would expect to see specific grade level charges that are very close across the full grade range. In fact, a few schools even charge a flat tuition rate across all twelve grades.

5. *Evaluate step 4.* Are the projected tuition rates or sets of rates from step 4 "reasonable" or "acceptable" to the trustees? If so, the planning process can be considered complete, and attention can turn to implementing the plan.

6. *Recycle, if necessary.* If the projected tuition rates at step 4 are not considered "acceptable," the planning process must revert to step 2 and cycle through again until an acceptable result is derived at step 5.

In actuality, things never proceed quite this smoothly in sequence. However, the proposed approach does represent a workable summary of what needs to be done and where the process starts and stops.

Formal financial planning: some other issues

In the financial planning process, certain questions and issues need to be addressed, as follows.

What is an appropriate time span for planning?

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Clearly, one year is too short, and ten years is quite probably too long. The key is to balance the loss of realism and confidence when a long time span is used against the overly restricted set of factors that can be varied when a short time span is used. Five years is a time span commonly used by businesses. The time span for a school should be at least three years. Five years is probably as long a time as should be considered in getting a planning process started in an independent school.

How often should the process be repeated?

It is important to realize that a financial plan is not something cast in concrete or something shelved until the three, four, or five years in the plan have passed. The plan is a living thing that needs to be re-evaluated continuously as the environment in which it was created changes.

It is not feasible, of course, to rework the plan weekly or even monthly, but the planning process should be repeated every year. Then, one new year is added to the plan as the current year drops out. In redoing the plan each year, it may also be necessary to change the projections for the intermediate years as well as adding a new year.

Changing the accepted figures for the intermediate years can conceivably hurt the credibility of the planning exercise. This problem needs to be handled carefully. However, if the environment changes from year to year, this problem is less serious than trying to make an old plan come true in an environment that no longer matches earlier assumptions.

Who gets involved?

The plan is not something the head can do alone or only with the business manager. As with the one-year budgeting process, described in Chapter 8, many members of the school community need to be involved in the planning process. Since the plan represents the projected coordination of the school's educational mission with its financial resources, it is imperative that all segments of the community, including the trustees, be involved and that they be committed to the courses of action implied by the plan. Clearly, there is always a sufficiently strong financial dimension to the planning process that the business manager and finance committee must play a major role.

Are planning documents desirable?

In planning for the future, the school should prepare formal financial planning documents for study and revision each year. Such documents help alert senior administrators and trustees to current trends and give those responsible for the financial well-being of the school a clear blueprint or profile of the financial makeup of the school.

How can inflation best be incorporated?

While it is true that future rates of inflation are extremely difficult to predict and that inflation represents a major uncertainty for schools, it is still possible to make meaningful plans. Inflation rates are more easily projected over three to five years than over ten years. Also, changes in the largest cost factor for schools—salaries—can be related fairly directly to changes in the cost of living, which is closely associated with the level of parent family salaries. Proportionate tuition adjustments are usually not too difficult to implement. However, serious attention should certainly be paid to forecasting inflation rates as accurately as possible. Errors in such forecasts are partially self-compensating for schools, though, so the problem is not normally a serious one.

A commonly used technique for treating inflation is to make all projections for all years in base year dollars so that amounts may be evaluated in terms of current purchasing power. Then a statement is added that all amounts will be increased for cost of living changes, whatever those turn out to be. For example, suppose the 1990 average faculty salary was $25,000 and the school wanted to raise it to $35,000 in five years, measured in 1990 dollars. The planning norm would be to raise salaries each year by $2,000 in 1990 dollars and then to add on the inflation factor.

What is the relation between the long-range financial plan and the annual budget?

The annual budget is really where the long-range plan is put into practice. The budget becomes the operational embodiment of the plan. When a viable long-range plan is in place for the school, the annual budgeting process should not involve major turmoil because the budget will reflect the trade-offs already agreed to in the process of creating the plan. In fact, most of the serious dilemmas that can plague the annual budgeting process result from failure to create an overriding, coordinated context for revenue and expense growth. The financial plan provides just such an overall guiding theme.

Part Three.
Administrative Issues

13.
Computerization of Administrative Functions

Computerization of the business office and the other major administrative functions within the school can provide tremendous benefits, regardless of enrollment. Productivity can be increased, information can be maintained in a more efficient and accurate manner, and administrators can use the results for analysis, forecasting, and decision making. *Computerization is a realistic and beneficial option for all independent schools.*

When discussing computerization at this level, it is impossible to avoid frequent use of technical terms. To explain concepts only in lay terms would be too cumbersome. Definitions of the terms used here can be found in any good computer dictionary. Given the current surge of interest in computing and its pervasiveness, all administrators should aspire to a level of understanding sufficient to permit reading a chapter such as this.

Computerization options

The automation of administrative functions can basically be accomplished in one of two ways: by purchasing a computer system and processing data internally, or by using an outside service bureau that provides reports based on data provided by the school.

This chapter was prepared with the help and cooperation of Blackbaud Microsystems, Inc., a South Carolina-based company specializing in software packages for independent schools.

Owned computers

The school that wishes to own a computer system has a broad range of options. Should it search for the systems that operate on a mainframe computer, a minicomputer, or a microcomputer? Unfortunately, no hard and fast definitions exist for each type of computer, and there is clearly overlap between the low level of one category and the high level of the next. For example, how does a "small" mainframe differ from a "super-mini"? To help sort out this confusion, here are definitions of each category of computer based on its major characteristics, followed by descriptions of multiuser computers and local area networks.

Mainframe

A mainframe computer always requires a data processing department of trained analysts, programmers, and operators to handle day-to-day operations.

- A mainframe computer is physically large. A complete system of processor and peripheral devices such as disk drives, tape drives, and printers requires a large, dedicated space with temperature and humidity control.
- The cost of the central processing unit alone starts at $250,000 and may well exceed $5,000,000.
- A mainframe computer can support 1,000 work stations.
- A mainframe computer has unlimited disk storage capacity, both fixed and removable.
- This computer has a huge amount of "virtual" memory available.
- Very little "canned" software is available. Applications are written by the organization's internal programming staff.
- Mainframes are used by large companies that handle tens of thousands or even millions of transactions.

Minicomputer

A minicomputer usually has a data processing department to handle day-to-day operations, though this is not essential.

- Hardware costs typically range from $15,000 to $100,000.
- A minicomputer can support up to 100 users.
- Disk capacities vary from 10 to 1,000 megabytes (MB).
- Memory ranges from 256 kilobytes (K) up to 8MB or more.
- A reasonable amount of "off the shelf" software is available, but many organizations write their own applications programs.

- A minicomputer does not necessarily require a trained person to operate the system, though this is recommended if full use is to be made of the equipment.
- Minicomputers are used by medium-sized and small organizations for business and financial applications and office management. They are also used by large corporations as a "front end" to the mainframe.

Microcomputer

A microcomputer does not require a data processing department to handle day-to-day operations.

- A microcomputer does not require any special temperature or humidity control for operation.
- A microcomputer, small in size, fits on a desktop.
- Central processing unit costs range between $1,000 and $10,000.
- A multi-user microcomputer can support a maximum of sixteen work stations. A local area network of microcomputers can link up to 256 users or more by employing advanced networking hardware.
- Disk capacity typically varies between 20MB and 160MB.
- Memory starts at 512K and can be expanded up to 8MB.
- A multitude of "off the shelf," user-friendly software packages are available for all types of applications.
- Microcomputers are used primarily by small and medium-sized businesses and individuals and as executive work stations in medium-sized to large corporations, with links provided to the corporate mainframe or mini.
- *The purchase of a mainframe computer is totally inappropriate for even the largest independent school. Further, relatively few successful, fully developed minicomputer installations are to be found in independent schools. Recent developments in microcomputing suggest strongly that minicomputers no longer represent a reasonable cost/benefit trade-off for independent schools not already committed to a mini. Microcomputers are very probably the best approach.*

The advent of the first microcomputers in the late 1970's sparked a computer revolution. The first machines were "hobbyist" in nature and considered to be for personal or home use only. Now, the latest products available are as powerful and sophisticated as the minicomputer of only a few years ago—or the mainframe of twenty years ago—and are replacing minis in many small businesses.

A fully operational single-user desktop system with 640K of memory, a 20MB hard disk, a dot matrix printer, and word processing and electronic spreadsheet software can be purchased for under $5,000. Each administrative function in the school can be computerized by using microcomputers with software specifically written for independent schools for well under $100,000—and hardware prices are falling all the time.

The microcomputer is here to stay and will continue to increase in power. The models currently available are suitable and powerful enough for even the largest schools and should always be considered over a minicomputer system.

What type of microcomputer system to buy? A stand-alone, single-user desktop machine will prove extremely beneficial in the business office. The school might wish to expand this system with additional users as the level of sophistication increases and budgets permit. In a typical workday situation, the business manager might wish to call up a student's account while the bookkeeper is entering cash receipts. How can this be achieved? Two choices are available to the school: the multi-user microcomputer and the local area network.

Multi-user microcomputer. Most multi-user microcomputer systems rely on a single central processing unit with a hard disk to which several "dumb" terminals can be connected. Each terminal can access information stored on the hard disk and share peripheral devices, such as printers. If the central processing unit or the hard disk fails, the entire system must be shut down until repairs are made.

Typically, a multi-user micro can support only a maximum of sixteen work stations. In reality, however, since a single microprocessor is doing all the work, response time (the speed at which information is returned to a work station after a request has been made) begins to deteriorate rapidly when five or more users are all working at the same time.

Local area network. Each user in a local area network has his or her own desktop microcomputer. The computers in the network are linked by cable. Each can have peripheral devices such as printers, can access and change information on any hard disk in the network, and can send messages to other users by electronic mail. If any component in the network breaks down, it can be removed for repair without affecting the rest of the system. Work may still be completed by using another work station.

Most local area networks will support between seventy-two and 256 work stations. Response times do not deteriorate when many users are on the network because each work station is a computer in its own right with its own microprocessor. Individual work stations can easily be detached from the network for use off the premises. This can be particularly useful if the work station is a portable microcomputer. The business manager could, for example, take it home over the weekend to work on the budget and print out the results back in the office first thing Monday morning.

The costs per work station are greater for the local area network than for the multi-user system. However, the school gets much more for its money, and cost will become less of a factor as hardware prices continue to drop. Because of the inherent limitations in a multi-user microcomputer system, if the school prefers that type of technology, a minicomputer is a better solution. *It must be emphasized, however, that the anticipated advantages of linking business, admission, development, and registrar functions through a single merged database in a multi-user microcomputer are more apparent than real.* Networking of free-standing micros is clearly the overwhelming choice of most microcomputer installations.

Outside service bureau

Before the advent of the microcomputer, using an outside service was the only method of computerization available to many schools because the cost of a minicomputer system was too high. The use of a service bureau relieves the school of the burden of operating computer equipment. The background work must still be done at the school, however, for people at the school must complete data entry forms that are supplied by the service bureau. The service bureau processes the data and returns it in finished form—as payroll checks, reports, journals, or student schedules. One problem is turnaround time—typically two to three days—and delays caused when errors requiring correction are detected. With a school-owned computer, reports can be printed on demand and corrections can be made immediately. Also, what the school spends for an outside service bureau might pay for a microcomputer system within two or three years, depending on the services purchased.

Payroll is one area where an outside service bureau may have merit. Many banks provide this service for a modest fee. The risks of the system's being down on payday are far greater than the risks in accounts receivable, disbursements, or student records. Also, security of payroll information is ensured when processing is done outside the school.

What can computerization accomplish?

The computer can help all areas of administration by providing information management and decision-making support. Initially, a system can be used to computerize basic management information in the areas of accounting, fund raising, student records, and admission. Once the system is functioning well and less time is spent on routine tasks, the computer can be put to more creative uses. Then, with a wealth of information so readily available, it can serve as a decision-making support tool by manipulating data that can be used for analysis, financial modeling, long-range planning, and problem solving.

What follows is a more detailed look at what to expect when computerizing each of the major administrative areas of the school: the business office, the development/alumni(ae) office, the admission office, and the registrar's office.

Business office

The functions of the business office can be broken down into four major areas: student receivables, accounts payable, payroll, and general ledger (including financial reporting).

Student receivables

A good computer system for student receivables can dramatically reduce the time involved in preparing bills and analyzing unpaid accounts. Some of the highlights to look for in a student receivables system are

- Flexible payment schedules. The system should allow payments to be handled the way the school currently does them, not require alteration of the school's payment terms to meet the demands of the system.
- Payment history. The system should store at least twelve months of historical detail for each student.
- Access to student information by name. Less sophisticated systems provide access only by number, which must be known or looked up first.
- Ability to handle advance deposits, grants, scholarships, and loans. *Many "off the shelf" systems cannot cope with the special needs of an independent school in these areas.*
- Automatic generation of fixed fees and charges. Often charges are fixed by grade level. To key this individually is very time-consuming.
- Automatic computation of late or finance charges. Many schools have their own ways of computing charges. The system should accommodate these differences.

- Automatic promotion of students at year end to the next fixed fee category.
- Automatic posting to the general ledger
- Generation on demand of journals and reports such as bills for selected students, cash receipts journal, aged receivables, late or finance charge report, transaction detail report, credit balance report, billing summary and school totals report, aged accounts report, and special lists for advance deposits, scholarships, financial aid, tuition refund plan, and accident insurance.

Accounts payable

A computer system for accounts payable can provide an accurate and efficient means of managing cash flow and controlling the expenses of the school. Here are some important elements to look for.

- Instant access to vendor and service provider by name
- Retention of at least one year of invoice history
- The ability either to pay all outstanding invoices or scan invoices for selection
- Distribution of invoices to multiple general ledger accounts
- General ledger account number validation, a feature that helps to minimize keying errors during data entry
- Handling of prepaid invoices and credit memos
- Computer-generated checks, with a listing of multiple invoices on the voucher stub
- Automatic posting to the general ledger
- Check-clearing option to facilitate bank reconciliation
- Generation on demand of journals and reports: purchase journal, cash disbursements journal, open invoice report, aged payables report, cash requirements report, pre-check review, check register, outstanding checks report, vendor analysis and activity

Payroll

A computer system for payroll should include an efficient means of calculating gross earnings for a variety of pay methods and frequencies. Such a system should greatly improve the speed and accuracy of payroll preparation and follow-up. Features to look for include

- Ability to handle weekly, biweekly, semimonthly, monthly, and special payrolls for salaried and hourly employees
- Retention of details for each paycheck for one year

- Ability to handle *pretax* deductions for qualified retirement plans and medical premiums (salary reduction)
- Ability to handle flexible spending plans (Internal Revenue Code, Section 125)
- Easy change of federal, state, and local tax tables. *(Beware of systems that tie the school to an annual table maintenance charge.)*
- Multiple miscellaneous deductions
- Ability to distribute pay for one individual over a number of departments—especially useful for budgeting faculty salary expense
- Maintenance of detailed personnel as well as payroll information on each employee
- Generation of paychecks, with a detailed breakdown on the stub of all deductions for the current pay period and year-to-date total
- Option of clearing checks to facilitate bank reconciliation
- Automatic posting to general ledger
- Generation on demand of journals, reports, and forms: payroll journals, 941 report, W-2 forms, deduction register, departmental summary report, pre-check review, check register, earnings records, automatic summary report of personnel statistics as requested each year by NAIS, personnel reports to facilitate annual salary reviews in schools where the head retains discretion in setting salary levels

General ledger

An adequate computer system for the general ledger should meet all normal accounting and financial control requirements, record all financial transactions, and produce timely and accurate financial reports—financial position, comparative operations, variance summaries. The general ledger package must also have the ability to function within a fund accounting context following the guidelines set forth by NAIS. Some additional features to look for are

- Complete audit trail of all transactions
- Maintenance of prior year, current year, and budget totals for up to thirteen accounting periods
- Maintenance of debit/credit balance integrity for each accounting period when making journal entries
- Automatic reversing of adjusting journal entries in the next accounting period, when appropriate
- Recurring journal entries, with either standard or changing amounts
- Retention of journal details for the current year

- Ability to allow adjustments to previous and future accounting periods
- Delay of year-end close to allow for audit adjustments
- Automatic accounting for net surplus/deficit at end of fiscal year
- Reconciliation of expenses by function and object of expenditure
- Production of journals by data range, source (cash receipts, for example), account range, fund, or department
- Interface with electronic spreadsheet application, such as Multiplan or Lotus 1-2-3
- Generation on demand of statements, reports, and journals: transaction edit list, trial balance, operating statements, balance sheets, budget and/or prior year comparisons with variances, transaction journals, general ledger report, financial statements consolidating multiple funds

Development/alumni(ae) office

A powerful computer system for development can dramatically improve the effectiveness of the school's fund-raising effort as well as day-to-day control over that effort. The system should maintain a comprehensive record of information for each potential donor (both constituents and organizations). *In fact, the single most important feature of any development package is the content and structure of the giving record.*

Typically, the information held should include full name with multiple salutations (depending on author); home, business, and alternate addresses; occupation; details on spouse, children, and relatives; colleges attended; and interests and affiliations. For each organization, multiple contacts must be maintained, with the ability to mail to one or to all.

Detailed giving history should be available for display or printing either by date (showing a complete donor profile), by fund, or by constituent group. It must be possible to distinguish among various types of gifts (such as gifts in kind, real estate, stocks and securities showing both gross and net value, and matching gifts).

A powerful but easy-to-use selection sorting option is essential. The school needs to be able to isolate or target a group based on whatever criteria are appropriate at the time. Printing of mailing labels, Rolodex cards, pledge reminders, phonathon cards, letters, and reports should be possible for subgroups.

Additional features that should be part of a development system are

- Quick access to constituent data. A delay of more than one or two seconds can soon become a nuisance.
- Access by name. Simple systems provide access only by number, which must be known or looked up first. Additional keys are essential for provid-

ing access by maiden name, constituent group, occupation, or whatever other criteria the development office may wish to apply.

- Data storage. Information to be stored often differs from one school to the next. Many systems can trap a school into someone else's idea of what data should be kept and how long.

- Giving history. A summary of giving is not enough. The ability to scan a donor's complete giving history should be available.

- Bulk mailing. Output in zipcode order is only the first step. Ideally, the system should batch output in the manner required for maximum postal savings.

- Integration with word processing. A complete link with a powerful word processing package is essential. General mailings to selected groups, acknowledgments, and pledge reminders are vital to effective operation. It must be possible to trigger personalized letters based on a multitude of variables. In addition, transfer of computer-readable text to printing houses for school publications can be a great advantage.

- Accounting. A link to accounting systems at the fund level helps both development and business offices to follow, and study, the impact of a campaign.

- Electronic spreadsheet. The ability to analyze statistics, project trends, and present figures graphically is becoming an essential part of successful development operations. It should be possible to pass figures at various levels of detail to one of the up-to-date spreadsheet packages.

- Reporting. The system must be capable of printing (and/or displaying) giving data in many detailed and summary formats. Analysis by fund, solicitation method, solicitor, or constituent group is just a start. It should also be possible to study and solicit special donor categories. Here is a sample list of required reports: cash receipts journal, gift entry report, outstanding pledges, matching gift reports, stock/security reports, gift-in-kind reports, alumni(ae) analysis by class, parent analysis by class, fund contributors, fund noncontributors, donor category report, fund summaries, solicitation method analysis.

- Planned giving. More and more schools are increasing their efforts in the area of planned giving. A sophisticated computer system for development should have the ability to calculate remainder values and present the options in graphic form to facilitate integration of formal estate planning with giving solicitations.

Admission office

A computer system for the admission office can provide accurate and dramatically efficient tracking of admission records from initial inquiry all the way through matriculation. Because schools differ widely in their admission practices, any system that is chosen must be compatible with the approach the school uses. The features of a computer system for admission should not consist of the information the system designer feels should be kept; they must be tailored to the school in question. A good system, rather than standardizing the admission process, will permit a more personal approach. Features to expect in a good admission system include

- Access by name (especially important to an admission officer who has a prospective parent waiting on the telephone). Access by applicant's name and both of the parents' last names can sometimes save embarrassment.
- Personalized form letters. A direct link to powerful word processing is essential to allow the appearance of a personal approach even when volume is too great to permit manual production of correspondence.
- Generation of *user-defined* reports and performance analyses, such as a breakdown of overall "yield" in terms of inquiries vs. applications, applications vs. acceptances, and acceptances vs. matriculants.
- Production of labels and envelopes for selected groups of applicants.
- Typical reports: applicant activity report, admission statistics, average admission testing scores, financial aid listings, new students entering by grade level, personalized form letters, telephone number lists by grade, applicant analysis by geographic area

Registrar's office/student records

Because independent schools pride themselves on serving the individual needs of their students, a computer system for student records must provide comprehensive recording of student and parent information, flexibility in the scheduling process, and easy access to student information. A full registrar's system should provide the following features.

- Access to information by student's or parent's last name
- Tracking of grades, achievements, and attendance
- Student ranking, grade-point average, and cumulative averages. Many schools compute these in their own way. A successful system must allow for this complexity.
- Honor rolls by class. Again, calculation must be flexible enough to suit the school's methods.
- Cumulative student record cards and transcripts

- Linking to word processing for bulk personalized mailings to various subgroups of students and parents
- Ability to enter required courses for groups of students.
- Automatic allocation and balancing of sections, if required
- College placement. Tracking of student applications to colleges, with analysis of success, is a valuable addition to any registrar's system.
- Lists, reports, and schedules to expect: report cards; grade sheets; transcripts; cumulative record cards; honor rolls by class; student ranking, grade-point average, and cumulative averages; attendance reports; class lists; student directory; schedule conflict exception reports; master and individual schedules for each student, teacher, and room; personalized form letters.

Other applications

In addition to computer applications in the major areas noted above, schools should consider the following applications: word processing, desktop publishing, spreadsheet, purchase orders, fixed asset management, food service management, inventory control, library management, and bookstore management.

Of these systems, word processing and spreadsheet are essential when installing a computer system. The word processor will interface with many other systems, such as development/alumni(ae), student records, and admission. The spreadsheet allows for easy manipulation of data and, hence, focus on analysis and assumptions used in the planning process. A great deal of effort can be saved if the general ledger interfaces with the spreadsheet, to alleviate the tedium of entering data.

The other systems mentioned each have their advantages. However, they tend to be the last elements in the computerization process. With these systems in place, the business manager can experience greatly improved control over most of the information in the office. A computer system for the library, for example, dramatically assists with daily record keeping while allowing students exposure to a library system similar to what they will find in a modern college or university library.

Choosing a system

Choosing a System • 13-13

Before embarking on a possibly expensive and certainly time-consuming search for a computer system, the school must first determine that a system is needed and will prove beneficial.

Questions must be asked. Do current manual procedures need to be changed? Will the introduction of a computer reduce costs, either immediately or over the longer term? Will a computer system make it possible to perform functions that were not feasible under manual systems?

A computer system should not be purchased to solve organizational, management, or staffing problems. A computer is not the panacea for such ills; in fact, to introduce expensive equipment into a disorganized office environment only exacerbates the situation. Good, solid manual procedures must be in effect before any sort of automation is introduced. When this is not the case, it must take first priority. This can easily be done in the business office, for example, by introducing a one-write system.

If the possibilities of a computer system are appealing, the search for the right solution should consist of three steps.

- The school must first undergo a thorough and complete needs assessment.
- The school must identify the software that best matches these needs.
- The school must determine which hardware best matches the chosen software.

To select hardware before selecting software is a mistake commonly made by organizations inexperienced with computers. When this happens, unless the organization is lucky and the right software is available, the hardware will, at best, be underused (only used for word processing and spreadsheet) or, at worst, gather dust in a corner.

Another common mistake is to accept donated computers. To the school with a tight budget, such a gift may seem like manna from heaven. Consider the following possible situation, however.

The donated computer arrives at the school amid much excitement, which is soon dispelled by the realization that no one knows what to do with it. A software house is hired to develop some accounting software, which ends up costing $100,000 and takes over two years to prepare. Worse still, annual maintenance on the hardware is $20,000.

Although this story may seem exaggerated, it has happened enough times, if less dramatically, to make it worth telling. While it may be politically difficult to turn down such a gift, the first two steps given above must be performed before the donation can be accepted. Such donations probably will be gratefully accepted by the teaching staff for academic use, for the school is much less vulnerable to specific software requirements in the academic context. But even then, the support costs of a minicomputer system need to be evaluated carefully.

Only after extensive planning can the introduction of computers in the school be successful. It is not an exaggeration or an idle threat to note that the world is littered with dramatic computer failures.

Needs assessment

Although a school might have an immediate need to computerize one particular aspect of its administration, the assessment of functional and informational requirements should be done on the broadest possible basis, encompassing all administrative areas of the school. Budgets will probably determine that everything cannot be done all at once. Besides, a time-phased overall strategy is the conceptually correct way to proceed. Only in this manner can standardization be maintained throughout the school and coordination among offices be facilitated.

The first step in determining what a computer can do for the school is to identify how the school operates without one by interviewing staff members to find out and catalogue what each person does. How much time is spent on specific tasks? How much paperwork is produced? How do people's duties fit in to the goals of the school?

The next step is to evaluate the information gathered and identify problem areas. Is too much typing of repetitive letters done? Is too much time spent searching through multiple files for particular pieces of information? Does preparation of the budget or status reports consume a large amount of time? Is the same piece of information duplicated many times throughout the school?

While this analysis is going on, it is useful to establish a computer search committee. This group should be composed of the head of each administrative department, faculty members who have some computer background (such as the computer science teacher), and one or two members of the board of trustees who have been through a similar process elsewhere or who have expert knowledge. Everyone involved in the decision should be familiar with the terminology and fundamentals of computing, which can be achieved by attending local seminars or by readings selected from the many computer publications available. The committee should set goals for itself, with deadlines attached, and see to it that these goals and deadlines are met.

If budgets permit, the school could hire a consultant to help with the needs assessment and with selecting a vendor. The right person can be invaluable in helping the school make the correct decision, but finding that person may be as difficult as finding the right computer system. The school should solicit recommendations from trustees, from other schools, from the school's accounting firm, and from directories supplied by reliable organizations. Another source of information is the Consultants Referral Service of NAIS. Once a potential candidate has been selected, references should be sought from previous clients.

The culmination of the study process should be a request for proposal (RFP) prepared by the school with the assistance of its consultant that details the school's computerization needs, both current and future, and solicits from vendors proposals that meet its criteria.

Selecting software

A number of vendors supply software packages that are specifically designed to meet the administrative requirements of independent schools. They also frequently advertise in school-related publications and exhibit their wares at national, regional, and local conferences, including the NAIS annual conference.

The school should ask these vendors to supply current literature, a list of clients, and an up-to-date price list. It should then ask those vendors who best match its needs to demonstrate their wares, preferably at the school. It is also a good idea to visit at least one school where a system has been installed and is functioning. Questions to ask are

- Is the software working as expected?
- What problems were encountered during installation?
- How good is the service and support?
- Is the documentation easily understood?
- How easy is the system to use?
- Was the training handled professionally and expeditiously?

Check out the financial status of each vendor with Dun & Bradstreet. Ask for a sample instruction manual to see how readable it is. Ascertain whether the software has true multi-user capabilities. Make sure that telephone modem support is available so that the vendor's programming staff can "dial in" to the school's computer and make emergency changes on the spot. Find out whether customization is available at reasonable rates so that any requirements peculiar to the school can be incorporated into the standard package. While it is very unlikely that the vender will supply the school with source code, legal provisions should be made in the contract with the vendor for the school to obtain source code in the event the vendor goes out of business.

The microcomputer industry is in a continual state of flux. Many hardware and software companies exist at present, and a constant shakeout is going on. The situation is much like that of the auto industry early in the century: only a handful of the strongest companies will survive. Before making its purchase decision, the school should investigate the finalist vendor's credibility. Has the company been around long enough to have produced well-tested, reliable products? How likely is the company to be around in years to come?

When comparing the costs of different systems, make sure that all "hidden" or additional costs have been considered. Determine the costs of such items as hardware maintenance, software maintenance, updates and new releases of software, hardware and software installation, training of staff, telephone "hotline" support, travel expenses for vendor's staff, new or special furniture requirements, office alterations to accommodate new equipment, special wiring and cabling, special telephone line for modems, and special supplies (continuous form paper, ribbons, diskettes, etc.)

As a final caveat, do not expect any vendor's software to match the school's specific present system or methods exactly. Take the one that best matches the school's needs and learn to live without the rest. Customization is a will-o'-the-wisp that is almost never worth the attempt or the cost.

The hardware choice

It is true that selecting the appropriate software is of paramount importance. But the existence of attractive software that only operates on hardware from one particular supplier does not necessarily mean that the school should purchase that hardware. Software needs must be blended with issues of hardware dependability.

As noted when discussing software choices, the microcomputer industry is in a continual state of flux. Not all of the currently competing companies are likely to survive. Before making a purchase decision, the school must investigate the vendor's credibility. Has the company been around long enough to have produced well-tested, reliable equipment? How likely is the company to be around in years to come? Check out the financial stability of the organization with Dun & Bradstreet.

Other considerations must be taken into account as well. Is the equipment technologically current or is it outdated? Is it part of the mainstream of present-day thinking and does it follow "de facto" industry standards? This last is of particular importance in connection with the operating system that determines which "library" of other software packages (including word processing, spreadsheet, project management, and communication applications) will be available to the school.

Also be sure that the hardware supports standard peripherals such as dot matrix printers, letter-quality printers, laser printers, and modems. Finally, make sure that the equipment can be expanded as needed. Determine what the maximums are in money and disk storage. If the school decides to start off with a single-user desktop microcomputer, determine whether it can be upgraded at a later date to form a multi-user system. These questions may not seem important at first, but they most certainly become important as the level of sophistication in computer usage increases.

From these discussions it should be obvious that a dilemma might develop. Conceivably, the school might determine that vendor A has the software best suited to its needs but that it runs only on hardware that is deemed suspect. On the other hand, vendor B's less desirable software may operate on hardware from a top-rated manufacturer that the school would be happy to purchase. A difficult decision faces the school. In reality, such a situation will probably occur less frequently over time as fewer and fewer computer companies develop software for microcomputers that do not adhere to industry standards.

Installing a new computer system

It is natural to assume that the purchase of a computer system will reduce workloads and help the school operate more efficiently—which it will, but not immediately. As with anything new, people need to learn, and this process takes time. The time it takes to become comfortable with a computer system depends on many variables, including the "user friendliness" of the software and hardware, the system documentation and training provided by the vendor, and the level of computer literacy of the staff who will be using the system.

The school should not expect to install the system one day and have it doing everything the salesperson promised the very next day. The school must allow a reasonable time for training. The school that purchases a system because a particular project must be completed "by next week or else" will be very disappointed.

Data entry

One of the highlights of a computer system is its ability to provide access to a wealth of information in a fraction of a second. Records currently stored in bulky file cabinets scattered around the school can be retrieved instantly—*after* those records have been entered into the computer. Someone has to consolidate information from all the manual files and key it into the computer. Depending on the volume of information involved, this initial data entry may take anywhere from several days to many weeks. A good example is the development office, which may have thousands of records for alumni(ae), parents, past parents, trustees, and friends. But until the database is computerized, the computer is virtually useless.

This procedure must be allowed for and carefully planned. *Resources may not be available to the school if all the staff members in the offices are already fully occupied. If this is the case, the school must consider hiring temporary help to get the job done.*

Running parallel

Even after all information has been entered into the system, the files and manual procedures should not be discarded right away. *The school should operate both the new computer system and the old manual system in parallel until sufficient confidence is gained in the computer.* Reports and charts produced manually should be compared with those produced by the computer. If differences occur, the cause must be determined. The school should not abandon tried and tested procedures until it is certain that the computer has adequately replaced them. In the short term, this increases workloads, but it proves worthwhile in the long run, once everyone is able to relax in the knowledge that all systems are functioning properly.

Some final concerns

The following cautionary comments apply to all computerized information processing in the school.

- *All computer files should be backed up on floppy disks or tape each day for storage on site and be backed up weekly and stored off the premises in case of major system malfunctioning.* Hard copy should be retained between backup runs so that the school is always protected from the destruction of critical files.
- All programs must be fully documented, even if the people currently operating them are the same people who wrote them. Without full program documentation, the school is too vulnerable to personnel changes.
- The advantages of common databases and integration of programs

across functions (as across business and development) are not really crucial. Some duplication of files is a modest price to pay for the tremendous flexibility gained from having several free-standing systems in place, each developing at its own pace and each using specific software designed for that application.

- It is important for the software vendor to guarantee that software will be updated whenever necessary to work on the latest operating systems supplied with the hardware.
- Security against unauthorized access to computer files is a major problem. Examples exist of students changing grades or deleting accounts receivable data. Some form of carefully designed password-controlled access is essential.

14.

Records Retention

It is important for the school to have a records management and retention program

- To ensure protection of vital records in case of destruction by fire or some other catastrophic event
- To assure compliance with state and federal laws governing retention of important records
- To maintain confidentiality of student, financial, and other restricted records
- To release storage space by disposing of records no longer needed

Records management checklist

The school should look at how it currently handles and stores its records. Here are some questions to consider.

- Does the school have a written policy on records management?
- Does the school have a guide or schedule for retaining records that meets state and federal requirements and follows generally accepted procedures?
- Does the school maintain student records in accordance with state and federal laws and with regulations governing maintenance of, access to, and dissemination of information from such records?
- Does the school have a system for storing permanent records?
- Does the school maintain a filing system that allows records to be filed and found easily?

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- Does the school have microfilm copies of essential paper records and backup disks or tapes of important computer records? Are these copies securely stored in a building separate from the originals, a bank vault, or a record archive?
- Does the school provide fireproof storage areas for permanent records?
- Does the school have a systematic program for transferring or retiring inactive records?

Taking a records inventory

As a beginning point, it is strongly recommended that the school take a physical inventory of all its records, which should provide the basis for an overall records program. The following information should be gathered.

- Location: number and name of department where the record is stored and of the department responsible for the record
- Record title: invoices, address files, alumni(ae) files, etc.
- Type of record and quantity: file drawers, ledger books, folders, tapes, etc.
- Dates covered by a record (a particular set of records may be divided among several inventory cards on the basis of dates covered by the records)
- Need: essential? desirable? unneeded?
- Access: degree of confidentiality determines access to the record and method of storage
- Second-copy decision: to be determined by the person taking the inventory; may also involve a recommendation on type of storage of second copy
- Additional comments
- Signature and date

Retention schedule

Exhibit 14-1 shows a suggested retention schedule for school records. Individual state requirements and a particular school's needs may dictate differing retention periods. The school should consult its legal counsel when questions arise.

Exhibit 14-1

Records Retention Guidelines

Type of record	*Retention period (years)*
Accounting	
Auditor's reports	Permanent
Audit work papers	5
Bank deposit slips	3
Bank statements	3
Budgets	2
Canceled checks	
Taxes	Permanent
All other	8
Cash disbursements journals	Permanent
Cash projections	2
Cash receipts journals	Permanent
Contracts (purchase and sales)	3+
Credit memos	3
Depreciation records	3+
Employee expense reports	6
Endowment records and reports	Permanent
Financial statements	
Annual	Permanent
Interim	3
Freight bills	3
General journals	Permanent
General ledgers	Permanent
Inventory lists	3
Invoices	3
Parent payments	10
Payroll records	8
Petty cash vouchers	3
Purchase journals	Permanent
Purchase orders	3
Purchase records	3
Subsidiary ledgers	
Accounts payable	6
Accounts receivable	6
Time cards and daily time reports	3
Trial balances	6
Corporate	
Articles of incorporation	Permanent
Bylaws	Permanent
Construction and major equipment records	Permanent
Contract bids	3

14-4 • Exhibit 14-1

Type of record	*Retention period (years)*
Contract and trademark registration	Permanent
Contracts and agreements	Permanent
Correspondence	
General	6
Legal	Permanent
Deeds and easements	Permanent
Long-range plan studies	9
Maintenance and repair records	9
Minutes	Permanent
Mortgage and note agreements	6+
Reports required by federal and state departments	Permanent
Insurance	
Accident reports	6
Fire inspection reports	6
Group disability records	8
Insurance policies	Permanent
Safety records	8
Settled insurance claims	10
Personnel	
Employment records	5
Retirement and pension records	Permanent
Personnel files	10 (after termination)
Sickness and disability records	6
Student and alumni(ae)	
Academic performance records	6
Admission folders	2
Comments and reports to parents	2
Fund-raising files	2
Grade lists	2
Transcripts	Permanent
Yearbooks	Permanent
Taxes	
IRS approval letters	Permanent
Payroll tax returns	6
Sales and use tax returns	Permanent
Tax returns	Permanent
Withholding tax forms	6

These guidelines are taken from two sources: (1) a reprint from Connecticut Business Times, June 1981, and (2) information from the U.S. Government Printing Office. In general, where variations occur, the more conservative number is used.